

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

HEARINGS BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE NINETY-NINTH CONGRESS FIRST SESSION

ON

THE NEED FOR COMPREHENSIVE LEGISLATION WHICH WILL PROVIDE
NATIONAL POLICY DIRECTION TO THE FEDERAL REGULATORS AND
FINANCIAL INSTITUTIONS TO ADDRESS THE COMPETITIVE ISSUES,
THE CONSUMER PROTECTION ISSUES, AND REGULATORY ISSUES
BEING RAISED BY THE ONGOING RAPID CHANGES IN THE FINANCIAL
SERVICES INDUSTRY

PART I

MAY 8, 14, 15, 22, 1985

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1985

48-521 O

5241-14

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COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

PART I

WEDNESDAY, MAY 8, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 9:15 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dodd, Dixon, and Sasser.

The CHAIRMAN. The Banking Committee will come to order.

This morning we are privileged to have several witnesses. The first, Chairman Paul Volcker, Board of Governors, the Federal Reserve System; Mr. William Isaac, Chairman, Federal Deposit Insurance Corporation; Mr. Joe Selby, Acting Comptroller of the Currency; Mr. Edgar Callahan, Chairman of the National Credit Union Administration.

OPENING STATEMENT OF CHAIRMAN GARN

On September 13, 1984, the Senate approved S. 2851, the Financial Services Competitive Equity Act. The House of Representatives, however, failed to take up the legislation or to pass any measure on which we could have gone to conference in the 98th Congress. As a result, S. 2851 died with the end of the last Congress.

The final Senate vote for approval for S. 2851 was an overwhelming 89 to 5 after surviving two filibuster attempts. I believe that the size of the margin reflects the Senate's recognition of the pressing need for legislation to address the competitive issues, the consumer protection issues, and the regulatory issues being raised by the ongoing rapid changes in our financial services industry.

S. 2851 was an amalgam of more than a dozen bills introduced by various Senators to address these issues. Hearings that eventually produced the consensus on S. 2851 began even before the beginning of the 98th Congress.

The Banking Committee's initial hearings on the need to expand the permissible securities activities of depository institution holding companies were held in April 1981, more than 4 years ago. During the 98th Congress the Banking Committee held an addition-

al 34 days of hearings on the issues addressed in S. 2851 before reporting the bill on July 17, 1984.

The extensive hearings held in 1981, 1982, 1983, and 1984 clearly defined the competitive, consumer, and regulatory issues that had been raised by the summer of last year. While the legislative process to address these issues came to an end with the adjournment of the 98th Congress, rapid changes in the financial services industry have not come to a similar halt.

After such an extensive process in the last two Congresses, the Senate Banking Committee does not need to start all over again. The issues have been defined; they have not changed since the 89-to-5 vote last September. The marketplace, however, continues to evolve. I have not completed my analysis of what modifications, if any, I will make to last year's bill, but I can assure you that the Senate will do more than just close loopholes. We could simply close loopholes, but if we did, new loopholes would develop overnight. What is needed is more comprehensive legislation which provides national policy direction to the Federal regulators and financial institutions.

Today, the Banking Committee will receive an update on the recent changes in the financial services industry from the Chairman of the Federal Reserve Board as I have mentioned and the other regulators as well.

The Chairman of the Federal Home Loan Bank Board as well as representatives of the Conference of State Bank Supervisors, National Association of State Savings and Loan Supervisors will appear before the committee on May 14.

On May 15, the committee will hear from the chief executive officers of national and international financial service firms discussing the major trends in their industries.

A panel of executive officers of regional and local financial service firms will appear before the committee on May 22. That same day the committee will also hear the views of noted consultants and other experts on the ongoing evolution of the financial services industry.

The Secretary of the Treasury has asked that he be permitted to present the administration's views at the conclusion of this stage of our hearing process. He will appear in the first week of June.

Finally, the committee will schedule subsequent hearings as soon as possible to give interested trade associations the opportunity to testify on these issues.

But I want to stress, we do not need to reinvent the wheel. We've had hundreds of witnesses. I look at Chairman Volcker and I don't know how many times over the years we have gone through this process.

Former Chairman Proxmire started it while I was the ranking minority member. We have years of testimony, thousands of pages, hundreds of witnesses.

Many of these issues were before the Congress before I even became a Senator, let alone chairman of the committee. I'm getting rather tired of being told year after year we can't do it this year but next January we will. I've heard that now for 6 or 7 years.

So we will hold these relatively brief series of hearings and then I do intend to push as hard as I possibly can for comprehensive

banking legislation this year. The time to act is not this year; it was last year.

I do believe there is a majority of this committee that feels this way. I have very much appreciated the support of Senator Proxmire through this entire process. Without his aid and help we couldn't have gotten as far as we have.

[The complete prepared statement follows:]

OPENING STATEMENT OF SENATOR GARN, OVERSIGHT HEARINGS ON THE
FINANCIAL STRUCTURE, May 8, 1985

On September 13, 1984, the Senate approved S. 2851, "The Financial Services Competitive Equity Act". The House of Representatives, however, failed to take up the legislation or to pass any measure on which we could have gone to conference in the 98th Congress. As a result, S. 2851 died with the end of last Congress.

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The extensive hearings held in 1981, 1982, 1983, and 1984 clearly defined the competitive, consumer and regulatory issues that had been raised by the summer of last year.

depository institutions in our financial system and our economy. For the convenience of the Committee, I have attached to this statement a copy of my statement before this Committee on March 27, 1984, which sets out in detail the conceptual framework from which we at the Board approach the present legislative effort to revise the banking structure in the light of changed market conditions. (Attachment I)

The legislation adopted by the Senate last year took some basic steps necessary to adapt the financial system to changed circumstances. It provided for:

- (a) a new definition of banks and thrifts;
- (b) a streamlining of the procedural provisions of the bank and thrift holding company acts;
- (c) a broadening, within an appropriate regulatory framework, of the powers of depository institution holding companies;

But, while the legislative process to address these issues came to an end with the adjournment of the 98th Congress, rapid changes in the financial services industry did not come to a similar halt.

After such an extensive process in the last two Congresses, the Senate Banking Committee does not need to start all over again. The issues have been defined -- they have not changed since the 89 to 5 vote last September. The marketplace, however, continues to evolve. I have not completed my analysis of what modifications, if any, I will make to last year's bill, but I can assure you that the Senate will do more than close loopholes. We could simply close loopholes, but if we did, new loopholes would develop overnight. What is needed is more comprehensive legislation which provides national policy direction to the federal regulators and financial institutions.

Today, the Banking Committee will receive an update on the recent changes in the financial services industry from the Chairman of the Federal Reserve Board, the Chairman of the Federal Deposit Insurance Corporation, the Acting Comptroller of the Currency, and the most recent Chairman of the National Credit Union Administration.

The Chairman of the Federal Home Loan Bank Board, as well as representatives of the Conference of State Bank Supervisors and the National Association of State Savings and Loan Supervisors will appear before the Committee on May 14.

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The CHAIRMAN. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman. I certainly agree with your remarks.

Today the committee embarks upon a hopefully brief set of hearings in the financial services industry. I say hopefully brief because the committee has already held—as you've said so well—exhaustive hearings on the structure of the financial services industry in the last Congress.

The time has now come for Congress to stop debating the issue and reach a decision. Last year's bill, S. 2851, was a reasonably good attempt to bring some order out of chaos. It was not a perfect bill but it was able to pass the Senate by an overwhelming vote of 89 to 5.

I believe, Mr. Chairman, that you could get a bill identical to S. 2851 through the Senate before the July recess provided we do not tinker with its provisions. To be sure every member of this committee is unhappy with some provision or other of S. 2851 but by and large it is a carefully balanced bill; it has the overwhelming support of the Senate as a package.

If we attempt to reopen all of the issues that were so carefully resolved last year, I'm afraid the fragile consensus on the overall package will unravel. Once that happens it could take us another 2 years to pass a bill.

My own sense of priority is that there is an imperative need for the Congress to deal with the various loopholes in our banking laws including the nonbank bank loophole. The House Banking Committee seems to be pursuing a two-track approach where the outstanding loopholes are closed in an initial bill and the broader structural issues are dealt with in a subsequent package.

Clearly, it would be preferable to resolve all issues in one bill as the Senate did last year in S. 2851. Nonetheless, the House approach has a certain appeal, particularly if we seem to be bogged down in the Senate on an omnibus comprehensive bill.

So, Mr. Chairman, I would urge you to move forward with all deliberate speed on last year's bill. We can get a major banking bill through the Senate before the July recess if we stick to last year's package and avoid any substantial changes. I'll certainly do my best to help you work toward that end.

Chairman Volcker, as you know, I've been a big Volcker fan ever since you became Chairman of the Federal Reserve Board but I must, frankly, say that I was very disappointed in your statement about favoring interstate banking. It may be that technology is going to overwhelm us but I think it'll be a grim day.

I have some questions for you on that when my time comes for questioning. Unfortunately, I'm going to have to leave and go to the floor in about 15 minutes but I'll be back shortly after that, and do my best to pursue you at that point.

Thank you.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No statement.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Mr. Chairman, I have a statement I will submit for the record. I commend you for calling the hearings and I hope the end result is going to be legislation in the very near future to eliminate the confusion which currently exists in the marketplace. To that end, I'm on your side. Let's get on with it and get legislation up, out, and passed.

STATEMENT OF SENATOR MATTINGLY

Mr. Chairman, I commend you on calling this oversight hearing, the first in a series of the "changes in the financial services industry." I hope the end result will be legislation in the near future to eliminate the confusion which currently exists in the marketplace.

Last Congress I introduced S. 2113, a bill designed to make clear each State's right under the Douglas amendment to the Bank Holding Company Act to determine the nature, scope, and timing of bank expansion permitted within and across each State's borders. A title to that effect, title X, became part of last year's S. 2851, which passed by a vote of 89 to 5.

Nearly half of all States have acted in some fashion under the Douglas amendment, including 14 on a regionally reciprocal basis, including my home State of Georgia. The Supreme Court has heard arguments on Citicorp's suit against the regional banking laws of Massachusetts and Connecticut, with a decision possible this summer.

Some would look at this and say, because each State has not enacted the same law, we should dictate how they act. Others would say, the Supreme Court is involved, let's wait for their decision. I say, neither response is advisable.

First, the fact that the States are acting under existing law demonstrates that progressive action is being taken under that statute. The general Federal prohibition on interstate expansion, which inhibits interstate banking commerce, is being removed in degrees by the States. The States, by enacting regional banking laws, are thereby promoting interstate commerce.

Second, I see no reason for us to wait for the Supreme Court to tell us what we intended by enacting the Douglas amendment. We should be letting the Supreme Court know what Congress intended, which was to delegate to the States the widest degree of latitude on decisions concerning bank expansion.

It is in this spirit in which I introduced title III of S. 716, a bare bones proposal intended to resolve a number of legal questions concerning financial institutions that are the subject of ongoing litigation or regulatory proceedings. I believe that it is important that we uphold each State's right to determine the nature, scope, and timing of bank expansion permitted within and across each State's borders by clarifying the intent of the Douglas amendment and I hope that we will act swiftly to repeat last year's effort in this regard.

The CHAIRMAN. Well, I agree with both of you and certainly agree with Senator Proxmire that I would like to have a bill before the July recess if we are through debating the budget and the floor can be cleared so we can talk about other things. I'm not too hopeful at this time that we'll be through with the budget by then.

Chairman Volcker, please proceed.

Chairman VOLCKER. Well, thank you, Mr. Chairman.

The CHAIRMAN. Excuse me just 1 minute.

Senator Dixon, do you have a statement?

Senator DIXON. With the leave of the committee, I'll put it in the record, Mr. Chairman.

STATEMENT OF SENATOR DIXON

Mr. Chairman, I am pleased to be here this morning to hear from the distinguished Chairmen of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the National Credit Union Administration, and the distinguished Acting Comptroller of the Currency.

I look forward to their testimony on current issues facing the financing services industry and I appreciate their recommendations for legislative action. I believe it is time to act; in fact, the Congress has delayed acting for far too long already. I know the chairman will agree with me when I say how fervently I wish we had been able to get last year's Senate bill enacted.

Conditions have changed somewhat since the last Congress adjourned. I am very much aware, for example, of the fact that the nonbank bank situation has changed considerably since the Senate first looked at that issue. Failure to address that issue legislatively, however, would be an abdication of our responsibility.

I hope the committee can act quickly, therefore, on a bill that addresses the issues contained in last year's legislation, and I would urge the chairman to handle other important issues in a separate bill. I believe the Senate must act and act quickly if we are to get the House to begin to move forward in any sort of comprehensive way.

I congratulate the chairman for scheduling this hearing, and I look forward to working with him, with the other members of the committee, with the witnesses here this morning, and with all those interested in addressing the problems facing banking and the other components of the financial services industry.

One final comment, Mr. Chairman. I would note for the committee that this is the final appearance before the committee of my friend and fellow Illinoisan, Ed Callahan, at least in his capacity as Chairman of the Federal Credit Union Administration. I want to take this opportunity to congratulate him for his great service in that post, and to say that I am sorry that the Government will be losing the benefit of his services. I have enjoyed working with him; I wish him well in his future endeavors; and I hope and expect that I will continue to have the opportunity to work with him.

STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. President, I am pleased to be here once again taking up the issue of deregulation of the financial services industry. The vast changes that have been proposed for this most important part of our economy need careful consideration. This hearing provides the committee with an important opportunity to closely question the regulators of our financial services industry to ensure

that any changes in that industry will add to the safety and soundness of our banks and savings and loans.

It is no secret that I have serious reservations about overturning the Glass-Steagall Act which has been essential to maintaining a solid banking system that has served us well for over 50 years. Our banks have served us well, I have heard few if any complaints about our banks. Which is another reason why I question the need to change drastically our banking laws. No constituents are marching down Pennsylvania Avenue demanding new powers for banks, demanding the right to buy securities from a bank or real estate or insurance from a bank. Why are we considering changing an industry—and reversing the act that is the cornerstone of that industry—if the banks are serving the consumers well?

Although I do believe we should err on the side of conservatism when debating changes in an industry upon which we have depended for over 50 years, I do believe it is our responsibility to ensure that whatever changes occur in the financial services industry occur only with the consent and blessings of Congress. Recent changes in the industry that have occurred by skillful exploitation of loopholes in the law may or may not be good for the banking industry and the American consumer—but I believe it is Congress' job to make that decision and allow the changes or disallow the changes, and I thank you, Mr. Chairman, for giving us another opportunity to fulfill this duty.

Mr. Chairman, I earlier mentioned the Glass-Steagall Act. It is worth recalling that this legislation was aimed at the abuses of the 1920's and 1930's that resulted from bank involvement in securities activities. Congress passed it to head off both conflicts of interest and future bank losses from speculative investments in securities. In spite of the protestations to the contrary of the big banks—the only folks I have seen marching down Pennsylvania Avenue asking for its repeal—and the banks regulators—who cannot be called disinterested spectators—the problems of speculation and conflicts of interest still exist.

In fact, new concerns about speculative investments have arisen recently. Many of us, most prominently my colleague from Wisconsin, Senator Proxmire, are becoming increasingly concerned about the issue of savings and loans investments in so-called junk bonds. Although the banks regulated by our guests here today are prohibited from investing in these low-rated or unrated bonds, I would like to bear their thoughts on this issue as well during our hearings today.

The CHAIRMAN. Senator D'Amato.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning Mr. Chairman. Today we will continue to hear testimony regarding the health and stability of the financial services industry. The time for review is prior to the presentation of a problem, that is why I wish to commend you for conducting this timely set of hearings. With the help of the witnesses testifying before this committee and the conscientious analysis of the industry by the Senators present, I believe this industry

will remain safe and equitable for all those who require its services.

The financial services industry is presently going under a certain metamorphosis never experienced before. As the industry changes, certain problems arise. What we have experienced in the past year are the result of a changing industry. Bank failures are the most noticeable of these problems. The problems caused by a changing financial market have served to create a growing fear among the public of whether the system is truly safe.

There is a general feeling by those concerned within the industry that something must be done. I believe this set of hearings provides the proper forum for pertinent and relevant information to be heard. It is my hope that this information can be used to help us cure the current problems in the services industry.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Good morning, Mr. Chairman.

The CHAIRMAN. Chairman Volcker.

Mr. VOLCKER. Good morning.

Let me say, first, I welcome you back in this familiar role, Mr. Chairman, with your feet solidly on the ground. I'd like to think there is a lot of challenge here before us and you've already stated that eloquently. I don't have to repeat the urgency of this matter; you have all made that point and I certainly hope that you will go ahead and clear up the confusion and give us a fresh sense of direction in the banking and financial institutions area.

The CHAIRMAN. If I could interrupt you for one very brief moment on your comment about me having both feet firmly planted on the ground. That, frankly, is not a very pleasant sensation and I would like to describe my trip very briefly by quoting one of my crew members, David Griggs.

In our first appearance after arriving back in Houston, each member of my crew was asked to speak for 2 minutes and then ask questions. Dave Griggs gave the best two-word speech I've ever heard in my life. He stood up before the mike, said nothing else but, "Gravity sucks." [Laughter.]

He got a standing ovation from his crew and he was absolutely right, it does. I just wish that I could show you how I could float up out of this chair to the ceiling and do loops and barrel rolls but, unfortunately, I cannot; I am earthbound and it's very disappointing.

Senator MATTINGLY. I would say you probably will once you pass this bill. [Laughter.]

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. There are challenges here. I can't be quite so brief and so eloquent, Mr. Chairman.

NEED FOR LEGISLATION INTENSIFIED

I have a rather brief statement; let me pick up on page 4, after making the point that I think the need for legislation is only intensifying as time passes. We have a lot more nonbank banks these

days, established by commercial companies, major securities, insurance, and retail firms.

We've had several hundred applications by bank holding companies for nonbank banks. There is a court decision by one district court in Florida that enjoins the Comptroller from issuing any new, final nonbank bank charters; we've returned all the pending applications, but I don't think that at all deters the need for legislation.

That lower court decision could be reversed. If it is, there will be a flood of new nonbank banks immediately put in place. Even if that court ruling is not reversed, it doesn't apply to nonbank banks authorized under State law or to existing national banks that could be converted into nonbank banks and then purchased by a nonbanking firm.

I fully expect the commercial firms prepared to take advantage of loopholes will turn in this direction as a means of evading the separation of banking and commerce that is now required.

The next important point I would make in terms of developments over the past year is that the trend in the States toward authorization of new nonbanking powers for banks and thrifts is accelerating.

These laws appear to be part of a kind of bidding process to attract and retain depository institutions in order to enhance revenues and create new employment opportunities within the State, rather than a reflection of any coherent philosophy toward banking.

These essentially competitive efforts in the end will offset one another, but at the cost of establishing banking practices that could well be inconsistent with the requirements of a safe and sound banking system.

Faced with these laws and their likely proliferation, the three Federal regulators with responsibilities in these areas—the Federal Reserve Board, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation—have each adopted or have under consideration regulations to establish a framework for the conduct of State-chartered depository institution activities.

The three depository institution regulators have, in effect, reached a conclusion that, unrestrained, these activities can seriously endanger depository institutions themselves and the financial system of which they are such an important part.

Administrative authority to act in this delicate area of State and Federal regulations needs a clear mandate of congressional support.

The unsatisfactory state of existing law is also manifest in recent applications for bank holding companies to engage directly or through subsidiaries in a considerable range of insurance and securities activities, taking advantage of perceived new interpretations of Federal law or new State laws.

Holding company applications are now before the Board to engage in nationwide insurance brokerage and underwriting through State banks and to participate in underwriting and distribution of commercial paper, revenue bonds, or mortgage-backed obligations.

These applications raise serious questions of policy in areas that have been of important congressional concern. Nevertheless, we

are required, by law to act on them. It would be far preferable to act in these areas on the basis of a fresh, statutory mandate.

All these developments have created a continuing large volume of complex litigation and more can be expected. Almost every important banking policy is now the subject of judicial review and the courts, or we the regulators, are faced with the unhappy dilemma of attempting to apply old laws adopted in very different circumstances to new facts and new arrangements which the Congress did not envisage when the laws were originally adopted.

In these circumstances, inconsistent rulings should be no surprise. The banking system is simply too important to leave its development to this haphazard arrangement.

The legislation adopted by the Senate last year would have made a major contribution toward establishing a new and more stable framework in which depository institutions and other financial firms can operate while also protecting the basic foundations of a safe and sound financial system.

However, I believe some changes are needed in at least three important areas to strengthen the Senate bill to assure that these objectives are fully met.

First, the so-called thrift test should be strengthened substantially. Conceptually, S. 2851 seems to accept the importance of assuring that thrifts extensively engaged in commercial activities, like commercial banks, be subject to national policy requiring a separation of banking and commerce.

However, the thrift test set out seems to me too weak; we permit nonthrift thrifts with bank-like powers to develop, undercutting the prohibition on nonbank banks.

To achieve the necessary strengthening, the thrift test should, at a minimum, require that at least 65 percent of a thrift's own assets be devoted to home lending. It should exclude a passthrough of loans originated and sold to other investors, an activity freely engaged in by a wide variety of institutions that have no special protection under Federal law, as well as by many commercial banks.

If liquid assets are to qualify they should do so only in amounts required by law. In addition, the thrifts should not be used to market the products of a nonthrift or bank parent and vice versa.

LIMITS TO STATE POWERS

Second, the provisions on limiting State powers to authorize new banking activities should be extended and clarified. The bill now prevents States from authorizing new powers for banks that are not permitted under section 4, of the Bank Holding Company Act unless those activities are confined to the authorizing State.

On the basis of recent developments, it seems clear this limitation should be extended to include activities authorized by States that are inconsistent with safe and sound banking.

Congress has extensively reviewed the powers that should be permitted to banks and their holding companies and has carefully balanced considerations involving both fair competition and risk.

We believe it's both unwise and dangerous to the stability of the system to permit the expansion of powers that raise serious safety and soundness considerations, particularly where the primary mo-

tivation for the adoption of these powers is parochial consideration of jobs and revenues.

Third, the legislation adopted this year should also go beyond approving regional arrangements and address the rules for interstate expansion more generally. The present situation of loophole exploiting and discriminatory regional arrangements is inherently unsatisfactory.

Title IX of the bill last year only goes as far as to legitimize regional arrangements for a period of 5 years. These arrangements are satisfactory only as a transition to a less discriminatory system of interstate banking.

New arrangements for interstate banking should also include provisions to assure fair competition and avoid undue concentration of resources, elements that could well be lost to the extent that interstate expansion is confined for an indefinite period to regional arrangements.

EFFORTS TO UNDERMINE THE BANK HOLDING COMPANY ACT

Finally, I'd like to emphasize one area where I believe a change should not be made. I understand proposals have been made by others to undermine the definition of a bank contained in S. 2851 by permitting nondepository institutions, industrial firms, retail firms, securities, and insurance firms, to enter the banking business without being subject to the Bank Holding Company Act, provided they have no more than a limited portion of their assets in commercial loans.

This concept, now beguilingly called the consumer or family bank, would clearly undercut the basic public policies sought by closing the nonbank bank loophole.

Moreover, I believe there is an important defect in the bill's definition of a bank. S. 2851 now exempts from the definition of bank institutions that take demand deposits and are not federally insured so long as they hold no more than 10 percent of their assets in commercial loans.

I have urged, and recent experience seems to me to confirm my concerns, that all institutions that take transactions accounts and make commercial loans and that are not covered by the S&L Holding Company Act should be covered by the Bank Holding Company Act.

For just these same reasons I would urge that the provisions of S. 2851, which allow bank holding companies to own nonfederally insured banks, be deleted from the bill.

I would also urge that the nonbank bank grandfather provisions of S. 2851 be modified to assure that the grandfather status is not abused by expansion of commercial lending or geographically.

In conclusion, Mr. Chairman, the Senate took a significant step forward toward adopting the urgently needed new framework of public policies for the conduct of banking and thrift business last year. Recent events have demonstrated the continuing need for final congressional action and I believe it created the atmosphere in which this action can be taken.

I believe S. 2851 provides a solid foundation but it needs to be strengthened in the areas I've indicated and I urge your early action.

I have attached a considerable amount of material to my statement to develop some of these points further, Mr. Chairman.

[The complete prepared statement follows:]

For release on delivery
9:00 A.M. E.D.T.
May 8, 1985

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U. S. Senate

May 8, 1985

I am pleased to appear before this Committee today to review the banking bill -- S. 2851 -- that was adopted by the Senate in September of last year and to assess the continuing need for this legislation. On several occasions in the past I have advised this Committee of the need to move with a sense of urgency to reform the existing statutory framework governing "banking" organizations, prompted by my concern that there are real dangers in permitting the financial system to evolve, as it is now, in a haphazard and potentially dangerous way. Nothing has happened in the seven months since September 1984 that would cause me to change this assessment. Quite the contrary, the basic framework for the conduct of depository institution business that would have been established by S. 2851 is sorely missed and still urgently needed.

In previous statements before this Committee, I have stressed the unique and complex role played by

(d) a better delineation of the scope of state authority in the area of banking organization powers; and

(e) a start on developing rules governing interstate expansion of depository institutions.

The broad consensus on these and other provisions was reflected in the overwhelming Senate support for S. 2851.

The need for new legislation to clarify and reinforce certain continuing goals of public policy toward banking has only intensified in the past year. There has been further proliferation of nonbank banks, new state initiatives to greatly expand the powers of state-chartered banks and thrifts, and new applications by banks and bank holding companies to engage in insurance, securities and other activities that must be decided with or without Congressional guidance.

Since July 1, 1983, the grandfather date in S. 2851, twenty-two applications for nonbank banks by commercial companies, including major securities, insurance and retail firms, have received approval. Since September 1984, 276 applications by bank holding companies for nonbank banks located in forty different states have also been approved. While a U. S. District Court in Florida has enjoined the Comptroller from issuing any new final charters, and the Federal Reserve has returned pending applications because of this injunction, there is a continuing and important need for legislative action on the definition of bank.

I need only stress that in the appeal process, the lower court decisions could be reversed, with a resultant flood of new nonbank banks immediately being put into place. In any event, the Court's ruling does not apply directly to

nonbank banks authorized under state law or to existing national banks, that could be converted to nonbank banks. I fully expect that commercial firms prepared to take advantage of loopholes will turn in this direction as a means of evading the separation of banking and commerce that is now required.

The accelerating trend in the states toward authorization of new nonbanking powers for banks and thrifts is another point of serious concern. These laws appear to be part of a kind of bidding process to attract and retain depository institutions to enhance revenues and create new employment opportunities rather than a reflection of a coherent philosophy toward banking. These essentially competitive efforts in the end will offset one another, but at the cost of establishing banking practices that could well be inconsistent with the requirements of a safe and sound

banking system. For instance, legislation was adopted last year in California and New York to authorize real estate development activities and in Ohio to authorize investment in corporate equities as well as real estate development, posing real risks for the banks that engage in these activities. Of equal concern is the legislation in some states that has given carte blanche to state-chartered thrifts allowing them to virtually make any type of investment almost without restriction.

Faced with these laws, and their likely proliferation, the three federal regulators with responsibilities in these areas -- the Board, the Federal Home Loan Bank Board, and the Federal Deposit Insurance Corporation -- have adopted or have under consideration regulations to establish a framework for the conduct of state-chartered depository institution activities. The three depository institution

regulators have in effect reached the conclusion that unrestrained, these activities can seriously endanger depository institutions themselves and the financial system in which they are such an important part. Administrative authority to act in this delicate area of state-federal relations needs a clear mandate of Congressional support.

The unsatisfactory state of existing law is also manifest in recent applications by bank holding companies to engage directly or through subsidiaries in a considerable range of insurance and securities activities, taking advantage of perceived new interpretations of federal law or new state laws. Holding company applications are now before the Board to engage in nationwide insurance brokerage and underwriting through state banks and to participate in underwriting and distribution of commercial paper, revenue bonds and mortgage-backed obligations. These applications raise

serious questions of policy in areas that have been of important Congressional concern. We are required, nevertheless, by law to act on them. It would be far preferable to act in these areas on the basis of a fresh statutory mandate, rather than attempt to apply existing rules to circumstances that were unforeseen 10, 20 and 50 years ago.

All these developments have created a continuing large volume of complex litigation -- and more can be expected. Almost every important banking policy is now the subject of judicial review and the courts, or we the regulators, are faced with the unhappy dilemma of attempting to apply old laws adopted in very different circumstances to new facts and new arrangements which the Congress did not envision when these laws were originally adopted. In these circumstances, inconsistent rulings should be no surprise. The banking system is simply too important to leave this to haphazard development.

The legislation adopted by the Senate last year would have made a major contribution toward establishing a new and more stable framework in which depository institutions and other financial firms can operate, while protecting the basic foundations of a safe and sound financial system. However, I believe changes are needed in at least three important areas to strengthen the Senate bill to assure that these objectives are fully met. (An Appendix, Attachment II, contains our recommended changes to Title I of S. 2851 in legislative language.)

Strengthening The Thrift Test

First, the so-called "thrift test" should be strengthened substantially. Conceptually, S. 2851 seems to accept the importance of assuring that thrifts extensively engaged in commercial activities, like commercial banks, be subject to national policy requiring a separation of banking

and commerce. However, the thrift test set out seems to me too weak, and would permit "nonthrift thrifts" with bank-like powers to develop, undercutting the prohibition on "nonbank banks."

To achieve the necessary strengthening, the thrift test should, at a minimum, require that at least 65 percent of a thrift's own assets be devoted to home lending. It should exclude a "pass-through" of loans originated and sold to other investors, an activity freely engaged in by a wide variety of institutions that have no special protection under Federal law, as well as by many commercial banks. If liquid assets are to qualify, they should do so only in amounts required by law. In addition, a thrift should not be used to market the products of a nonthrift or bank parent and vice versa.

Clarification of State Banking Powers

Second, the provisions on limiting state powers to authorize new banking activities should be extended and clarified. The bill now prevents states from authorizing new powers for banks that are not permitted under section 4 of the Bank Holding Company Act unless these activities are confined to the authorizing state. On the basis of recent developments it seems clear this limitation should be extended to include activities authorized by states that are inconsistent with safe and sound banking. The Congress has extensively reviewed the powers that should be permitted to banks and their holding companies and has carefully balanced considerations involving both fair competition and risk. We believe it is both unwise and dangerous to the stability of the system to permit the expansion of powers that raise serious safety and soundness considerations, particularly

where the primary motivation for the adoption of these powers is parochial considerations of jobs and revenues.

Transition to Interstate Banking

Third, legislation adopted this year should also go beyond approving regional arrangements, as provided for in Title IX of S. 2851, and address the rules for interstate expansion. The present situation of loophole exploitation and discriminatory regional arrangements is inherently unsatisfactory. Title IX only goes so far as to legitimize regional arrangements for a period of five years. These arrangements are satisfactory only as a transition to a less discriminatory system of interstate banking. New arrangements for interstate banking should also include provisions to assure fair competition and avoid undue concentration of resources, elements that would well be lost to the extent that interstate expansion was confined for an indefinite

period to regional arrangements. I have attached to my testimony a more detailed exposition of our thinking in this area. (Attachment III)

Definition of Bank

Finally, I would like to emphasize one area where I believe a change should not be made. I understand that proposals have been made by others to undermine the definition of bank contained in S. 2851 by permitting nondepository institutions -- industrial firms, retail firms, securities and insurance firms -- to enter the banking business without being subject to the Bank Holding Company Act, provided that they have no more than a limited portion of their assets in commercial loans. This concept, now beguilingly called the consumer or family bank, would clearly undercut the basic public policies sought by closing the nonbank bank loophole. A detailed statement on the nonbank

bank issue that also focuses on the reasons why the so-called consumer or family bank should not be included is contained in Attachment IV.

Moreover, I believe there is an important defect in the bill's definition of "bank". S. 2851 now exempts from the definition of bank institutions that take demand deposits and are not federally insured, so long as they hold no more than 10 percent of their assets in commercial loans. I have urged, and recent experience seems to me to confirm my concerns, that all institutions that take transaction accounts (not just demand deposits narrowly defined) and make commercial loans and that are not covered by the S&L Holding Company Act should be covered by the Bank Holding Company Act. For just these same reasons, I would urge that the provisions of S. 2851 which allows bank holding companies to own nonfederally insured banks be deleted from the bill.

I would also urge that the nonbank bank grandfather provisions of S. 2851 be modified to assure that grandfather status is not abused by expansion of commercial lending or geographically.

Last year the Senate took a significant step forward toward adopting the urgently needed new framework of public policies for the conduct of the banking and thrift businesses. Recent events have demonstrated the continuing need for final Congressional action and I believe have created the atmosphere in which this action can be taken. I believe S. 2851 needs to be strengthened in the areas I have indicated and strongly urge your early action.

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For release on delivery
Expected at 9:30 A.M. EST
March 27, 1984

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

March 27, 1984

I am pleased to come before you as one of the concluding witnesses in what has been a thorough and searching examination of proposals to restructure the law governing bank and thrift holding company activities. These hearings are a culmination of a long process of evaluation of legislative proposals to simplify regulatory procedures and to assure a competitive environment for the provision of financial services.

Hearings on various bills of this kind began in the fall of 1981. Since then this Committee has held 44 days of hearings, heard more than 235 witnesses, and has before it over 7,000 pages of testimony. This extensive record -- including analysis of historical problems, present difficulties, and future solutions -- provides a solid foundation on which to build legislative decisions at this session of Congress.

I have on several occasions emphasized to this Committee the basic framework within which we in the Federal Reserve approach these questions. We want to see a competitive and innovative banking and financial system, providing economical and efficient services to consumers. At the same time, we believe that banks, and depository institutions generally, perform a unique and critical role in the financial system and the economy -- as operators of the payments system, as custodians of the bulk of liquid savings, as unbiased suppliers of short-term credit, and as the link between monetary policy and the economy. This unique role implies continued governmental concerns about the stability and

impartiality of these institution -- concerns that are reflected in the federal "safety net" long provided by the discount window and deposit insurance, by regulatory protection against undue risk, and by policies to discourage conflicts of interest and undue concentration of banking resources. As a corollary to these concerns, and as a result of our practical experience in regulating bank holding companies, we also believe that these basic policies must, to a degree, apply to the holding companies of which banks and other depository institutions are a part; banking institutions cannot be wholly separated from the fortunes of their affiliates and from the success or failure of their business objectives.

A review of the testimony before this Committee indicates that these principles are broadly accepted. Progress has been made toward achieving some convergence of views on the definitions of a bank and thrift institution, on the scope of regulatory authority, and on possible simplification of regulatory approaches toward bank holding companies.

In my testimony in January in Salt Lake City, I suggested new legislation is urgently needed dealing with several areas:

- (a) a strengthened definition of bank;
- (b) a definition of a qualified thrift;
- (c) new procedures to streamline application of the bank and thrift holding company Acts;

- (d) the powers of depository institutions holding companies; and
- (e) statutory guidelines to govern the division of state and federal authority in the area of banking organization powers.

There are a growing number of issues about interstate banking that soon will need to be dealt with as well, but, with one exception, those questions could be deferred to later legislation. The exception concerns Congressional policy toward the present movement toward regional interstate banking arrangements.

Our analysis of the bills and much of the testimony that have been placed before this Committee indicate elements of agreement in several of the necessary areas. There appears to be an emerging consensus on defining what is a bank -- a fundamental building block for any legislation to clarify the role of banks and bank holding companies within our financial and economic system. New procedures for applying the Bank Holding Company Act and simplifying regulation seem to be broadly accepted. Some convergence on the appropriate role of thrift institutions and their holding companies may be developing, as well as on the need to rewrite guidelines for state-federal relationships. Equally clearly, substantial differences in defining the appropriate range of powers for bank holding companies remain apparent.

It seems to me the time has come to consolidate areas of agreement, to consider objections to the proposals before the Committee, and to test alternative approaches to bridging the remaining differences. Today, I would like to share with you our further thinking on the five key problem areas and, in particular, address some possible solutions to the remaining problems.

I. Definition of Bank

The definition of "bank" is a crucial provision of the Bank Holding Company Act. It defines those institutions which are covered by the Act, and for them the boundaries for the safeguards against excessive risk, conflicts of interest and concentration of resources deemed appropriate as a matter of public policy. The application of these policies depends upon a meaningful definition that encompasses all depository institutions that perform essential banking functions.

Marketplace, technological, and regulatory developments have seriously undermined the present definition, which defines a bank as an institution which accepts demand deposits and makes commercial loans. Functional evasion of the purpose of the Act is becoming the rule rather than the rare exception through the creation of "nonbank banks" and other devices that permit combinations of banking activity and commercial, retail, insurance and securities firms. As a result, established policies on conflicts of interest and concentration of

resources are undercut or jeopardized. These same techniques are being used to undermine the Congressional prohibition on interstate banking. The haphazard exploitation of "loopholes" in existing law is reflected in an understandable sense of competitive unfairness and could, in time, jeopardize the safety and soundness of the banking and payments system. The developments are broad in scope, as reflected in the tabulation in Appendix A.

To deal with this situation, last year we suggested a re-definition of the term "bank" to include any depository institution (other than a FSLIC insured institution) that is (a) FDIC insured, (b) eligible for FDIC insurance, or (c) which takes transaction accounts and makes commercial loans. This definition was included in the FIDA legislation and was adopted in Senator Proxmire's bill (S. 2134) and a number of bills introduced in the House.

Our review of this proposal in the light of comments made at the hearing suggests consideration should be given to three changes. First, industrial banks that are not federally insured and do not offer deposit accounts with checking or other third party transaction capabilities should be excluded. Appendix B describes these institutions and the scope of their activities.

Second, state-chartered thrift institutions (also described in Appendix B), which are not federally insured and

which would have been covered by the definition of bank described above, should be encompassed within the same holding company rules as federally insured S&Ls because of the focus of many of these state institutions on home lending. These institutions could be exempted from coverage by the Bank Holding Company Act if the relevant state regulator certified their activities were appropriately confined.

Third, the nonfederally insured thrifts and industrial banks that would be excluded from the coverage of the Bank Holding Company Act should be subject to rules which would prevent "tandem" operation -- that is, joint sale of banking or thrift products or integrated operations -- of these institutions with owners engaged in impermissible activities for bank holding companies. This limitation, on which we place considerable importance, is explained in detail in Appendix C. Its basic objective is to prevent the kinds of tying that are judged to be unfair or unsound for depository institutions, including joint offering of deposit products or loans with other products of affiliated industrial and commercial firms.

We believe that Congress should not exempt the so-called "consumer bank" from the definition of a bank. Such a proposal is contained in Section 104 of S. 2181, which would allow a "consumer bank" to take all forms of deposits, including transaction accounts, and make consumer loans, as well as a wide variety of other types of credit extensions, including some commercial loans.

Such an approach would permit commercial and industrial firms to enter into essential depository institution activities, including access to the payments system, in a manner that would inevitably undermine public policy objectives incorporated in the Bank Holding Company Act generally, and there would be the appearance of unfair competition with banks subject to the Act. In such circumstances, the regulated banking sector would inevitably wither and much of the banking business would take place in institutions not subject to the policy restrictions on risk, conflicts of interest, and concentration of resources. The lengthening list of nonbank bank acquisitions demonstrates that we are beginning to see that migration today. In this connection, I would point out that 19% of commercial banks now have commercial loan portfolios (narrowly defined) equal to not more than 5% of assets and that 47% have 10% or less of their assets in this form. Thus, almost half of the number of commercial banks in this country, could, with some minor restructuring of their portfolios, conduct basically the same activities as they do today and escape application of the policies of the Bank Holding Company Act.

Finally, I believe competitive equality requires that the recent and current proliferation of nonbank banks not be blessed by grandfather provisions, subject to a reasonable period of time to permit divestiture where this is necessary.

II. Definition of Qualified Thrift

Essentially the same problems of consistency with the public policy objectives of the Bank Holding Company Act arise when commercial and industrial firms acquire thrift institutions, particularly in the light of the broader powers provided such institutions in recent legislation. Indeed some state initiatives have provided state-chartered thrifts essentially the full panoply of banking powers and more. At the same time, there may be institutions with no restrictions on the activities of the parent firm, an ability to obtain long-term government-sponsored credit, favorable tax treatment, and a freedom to branch intrastate and interstate -- privileges that are denied commercial banks. As in the case of nonbank banks, there has been increasingly clear recognition of the need to adopt rules to assure equality of treatment of various kinds of depository institutions exercising similar or overlapping powers. The need for action is reflected in the strong interest of a variety of financial and nonfinancial businesses in the acquisition of thrifts in order to benefit from thrifts' bank-like powers, to gain access to federal deposit insurance, and to participate in the payments mechanism.

The Administration proposals attempt to deal with this question by requiring all thrifts, with certain exceptions for grandfathered service corporations, to meet the requirements of bank holding companies. This approach has been opposed mainly

on the grounds that it is not necessary to apply the same rules applicable to bank holding companies to those thrifts that concentrate their assets in home mortgages. In an attempt to recognize these concerns, the concept of a "qualified thrift" has been developed, reflected in the proposals of both Senators Garn and Proxmire, to exclude thrifts truly specializing in residential mortgage credit from comparable rules to those limiting the scope of activities of bank holding companies.

We would support this general approach. Thrifts that meet an adequate "specialization" test rooted in the public policy concern of support for residential mortgage lending could be owned by commercial or industrial firms as unitary thrifts are now.

In developing the specifics of such an approach, we would endorse the recommendation of the FHLBB that an underwriter of corporate debt and equity not be permitted to own a thrift, whether or not it meets the qualifying assets test. We would also rely upon a single direct test of the proportion of assets held in residential mortgages or mortgage-backed securities. An optional test of limited commercial lending, such as not more than 25% of its assets in certain qualifying commercial loans, as proposed in S. 2181, would leave open the clear possibility that institutions not engaged substantially in home mortgage lending would retain the

liberal treatment with respect to permissible activities now accorded to unitary S&Ls. For example, with such a test, 75% of all commercial banks today could be treated as thrifts because they have less than 25% of their assets in qualifying commercial loans; only six commercial banks would qualify under the 60% of assets in residential mortgages part of the dual test of S. 2181.

We believe an appropriate test would require that to be eligible for unitary savings and loan holding company treatment, institutions must devote at least 65% of their assets to residential mortgages or mortgage-backed securities. For this purpose, mortgages would include both 1-4 family and multi-family dwelling mortgages, mortgage-backed securities, mobile home loans, loans for home improvements, including participation interests in such instruments. Based on this definition, according to our calculations, almost three-fourths of FSLIC institutions would currently meet this test. We also believe the limits on commercial lending set in the Garn-St Germain Act remain appropriate for federally chartered institutions, and in the light of the much wider powers provided by some states for commercial lending, a supplementary (not optional) limit on commercial lending could be considered for eligibility of these state-chartered institutions.

We recognize some S&Ls and mutual savings banks that could not meet the qualified thrift test currently, but still wish to emphasize home lending and who wish to retain the

privilege of "unitary" S&L treatment, should be permitted a substantial period in which to conform their activities. During this transition period, which could be five to ten years, milestones should be set in terms of measuring progress toward achieving the required asset composition. While ownership by an industrial or commercial firm could be retained during the transition period and thereafter, we do not believe such thrifts should be permitted to operate in "tandem" with the parent commercial or industrial firms. (The details of this suggestion are outlined in the form of legislative language in Appendix D. The description of the limitations on tandem operations is, as noted above, contained in Appendix C.)

In general, under this approach, those thrifts (and their service corporations) not meeting the asset test (or in transition toward them) would generally have to conform to the limitations on ownership of, and powers provided to, bank holding companies generally. Special tax benefits and the access to long-term credit from the Home Loan Banks for these nonqualifying institutions should be reviewed. At the same time, methods should be developed to permit mutual institutions to take advantage of powers permitted bank or thrift holding companies in stock form.

III. Bank Holding Company Procedures

The third core element of legislation is the provisions on bank holding company procedures. S. 2181,

S. 2134, and FIDA contain essentially identical provisions on this point and I believe that this reflects widespread support for procedural simplification.

These provisions make improvements in two major areas: they change the present somewhat complex applications process into a notice procedure; and they put bank holding companies on more equal footing with their competitors by changing the "benefits vs. adverse effects" test and formal hearings requirements. Instead, new activities could go forward, after notice to the Federal Reserve Board, unless the Board found grounds for disapproval under specific statutory criteria. Those statutory tests include adequacy of financial and managerial resources, protection of impartiality in the provision of credit and avoidance of adverse effects on bank safety and soundness.

The thrust of these provisions, and a provision reducing the scope for judicial review by competitors, is intended to reduce the burden placed upon bank holding companies by government regulation to a minimum level consistent with protection of the public policy interests embodied in the specified criteria. Agency procedures would not be burdened by formal hearings and judicial review at the instance of competitors. Formal rulemaking procedures would, of course, remain necessary before decisions to add new activities to the list of permissible holding company powers,

and the Board could continue to request public comment on notices and hold informal hearings, where necessary, to obtain information necessary to make decisions.

We also believe the new procedures set out in S. 2181, S. 2134 and FIDA provide the Board with adequate supervisory authority over the activities of the holding company and its nonbank subsidiaries after they are in operation. Those procedures would emphasize the desirability of relying upon other regulatory agencies, such as the Commodity Futures Trading Commission in the area of commodity brokerage and the SEC in the case of securities activities, for supervisory and reporting requirements in order to avoid unnecessary duplication of effort. However, the statute provides adequate authority to take whatever regulatory or data gathering steps that may be necessary to ensure compliance with the Bank Holding Company Act.

My conclusion is that these provisions adequately balance the need for reducing unnecessary regulatory burdens with the requirements for adequate supervision to enforce fully the provisions of the Bank Holding Company Act. These provisions seem to me ready for inclusion in legislation.

IV. New Activities of Bank Holding Companies

The fourth element of needed legislation is expanded powers for holding companies. S. 2181 provides new authority for holding companies to: (a) sponsor and distribute mutual

funds and underwrite and distribute revenue bonds and mortgage-backed securities (b) engage in real estate brokerage and development, (c) provide insurance brokerage and underwriting, (d) own a thrift institution, and (e) take part in other services of a financial nature.

Considerations of competitive equality and potential benefits to consumers of a broader range of suppliers of financial services strongly suggest a presumption broadening the range of powers permitted bank holding companies. The point is reinforced by technological developments that enhance the options in the delivery of such services. However, as I stressed at the outset, those objectives must be balanced against other public policy concerns: assurance of fair and open competition in the provision of credit and other services, maintenance of impartiality of banks in credit judgments, and avoidance of practices that can undermine the strength of the bank itself. Balancing these objectives is surely the most difficult task before you.

Certain of the proposed activities, including those involving essentially "agency" activities, such as real estate and insurance brokerage, raise few questions of safety and soundness. In certain other areas, such as real estate development, much more significant risks to the holding company, and potentially to the bank itself, arise. Questions about conflicts of interest and tying for a number of the

activities have been discussed in detail by the witnesses that have preceded me in recent weeks.

Review of comments made during these hearings and other information has suggested a number of areas in which the Committee might bridge differences by modifying or limiting earlier proposals. In particular, we have attempted to address carefully the safety and soundness and the competitive fairness considerations that appear to stand in the way of broad agreement on a substantial broadening of bank holding company powers. In my testimony today I would like to review each of the categories of proposed new activities in light of those considerations.

(a) Securities Activities - Underwriting Municipal Revenue Bonds and Mortgage-backed Securities, and Sponsoring and Distributing Mutual Funds

Both S. 2181 and S. 2134 would authorize bank holding companies to underwrite municipal revenue bonds and similar instruments and to sponsor and distribute mutual funds. The Board supports both of these activities, based on a considerable period of experience with bank underwriting of general obligation bonds and managing trust assets. The Board believes that these activities involve a manageable degree of risk for banking organizations and there is potential for substantial gain for customers in terms of a variety of services and lower costs.

At the same time, bank performance of these services has been opposed because of several concerns. One line of concern suggests that the provision of credit by a bank affiliate, or guarantees of underwritten obligations by bank affiliates, would provide a distinct advantage to bank affiliated underwriters, or that temptations to link underwriting and loan business would be strong, to the potential detriment of the bank or its customers. It is alleged that investment flows might be influenced by the bank's interests, or that poor investment or underwriting performance by a holding company affiliate might reflect adversely on the bank itself.

We approach these arguments with some care taking account of the fact that bank underwriting of corporate securities is not proposed and of the rather successful coexistence of bank affiliated and independent underwriters of municipal general obligation bonds. Moreover, S. 2181 and S. 2134 already contain a number of provisions specifically designed to promote competitive equity and limit risk to affiliated banks.

Those bills already require that all securities activities of the holding company, including its subsidiary banks, be conducted in a separate holding company affiliate. The affiliate must be separately capitalized in a manner comparable to similar firms not affiliated with a bank holding

company. The present rules contained in section 23A of the Federal Reserve Act and the proposed new section 23B would limit intercompany transactions and require that they be on market terms. All these provisions provide fundamental protections against conflicts of interest and unequal tax and regulatory treatment.

Nevertheless, a cautious approach in this area is justified and a number of suggestions proposed by others to assure competitive equity and avoid conflicts deserve attention. Thus, it may be reasonable to prohibit a bank holding company's securities or investment company affiliate from using the name of an affiliated bank or bank holding company (in the interest of appropriate disclosure, an indication of company affiliation should be permissible). It may also be desirable to require that the officers and employees of a securities affiliate or investment company advisor be separate from those that operate an affiliated bank, and that information on the financial activities of the bank's customers not be made available to the securities affiliate and vice versa. Banks might be prohibited from guaranteeing or providing letters of credit to support obligations that are underwritten by a securities affiliate.

So far as mutual funds are concerned, the existing provisions of the Investment Company Act, together with the applicable suggestions above, appear generally adequate to

assure independent investment judgment. However, those provisions could be reviewed to determine if any other special provisions are necessary to assure independence from the bank affiliate.

I have noted in earlier testimony a trend toward conglomerates of financial services, and toward the explicit or implicit tying of various financial products by financial conglomerates not including banks. To assure competitive equality, I believe that restrictions of the kind I have described above, if adopted, would need to be accompanied by provisions giving the Board certain discretion in their application should nonbank conglomerates develop combinations of services prohibited bank holding companies.

Questions have also arisen over bank holding company participation in brokerage services. The Federal Reserve, as you know, has permitted "discount" brokerage -- that is, the passive provision of brokerage services without investment advice -- under present law. Because that ruling is under court challenge, we believe it should be explicitly provided for in the proposed legislation. You may wish to review, however, the further question of the appropriateness of combining such services with investment advice -- that is, providing a full range of brokerage services -- within the framework of a bank holding company.

The mortgage market is being transformed by innovations in communications technology and in marketing techniques. Banking organizations are major mortgage lenders and are familiar with the credit analysis and have other expertise necessary to establish mortgage pools and evaluate the underlying risks of the constituent elements in the pool. They can already underwrite mortgage bonds guaranteed by the government or sold by government-related agencies.

What is at issue here is whether a bank affiliate should be permitted to underwrite private securities. Should the authority be confined to securities backed by 1-4 family mortgages, potential risks would be substantially defused. Risks and conflicts of interest in bank holding company participation in underwriting in those circumstances would appear to be manageable within the confines of the anti-tying rules already contained in present law and in S. 2181. As in other areas, however, questions of competitive equity have been raised, particularly in view of the ability of depository institution holding companies to provide, through their subsidiary banks, guarantees or letters of credit to support mortgage pools established and underwritten by securities affiliates. The appropriateness of combining those two aspects of financing services could be re-examined.

In summary, we believe adequate techniques are available to satisfy legitimate concerns about bank holding

company activity in the securities area, so long as corporate security underwriting remains prohibited. The potential benefits to competition and in terms of reducing underwriting costs, in these circumstances, point to action along the lines proposed by the Administration, and by Senators Garn and Proxmire.

(b) Real Estate Brokerage and Development

As I suggested earlier, the main issue in providing authority for bank holding companies to engage in real estate brokerage is not risk but potential conflicts of interest and problems of competitive equity. It has been suggested that the ability of a bank holding company real estate broker to offer assured bank financing, or even the impression that such assured financing is available because of the ownership tie between affiliated broker and bank lender, could be sufficient to divert business away from the independent and toward the bank or thrift affiliated broker.

As with the case of securities affiliates, limitations on the holding company broker using the same name as the holding company or its subsidiary bank, strengthening the already strict rules against explicit or implicit tying, and enhancing enforcement through providing a private right of action, could provide considerable protection against abuse. Possibly, a further step could be taken by prohibiting any mortgage loans by a subsidiary bank or thrift of a depository

holding company to any customer of an affiliated real estate brokerage firm.

It should not be necessary -- nor would it seem fair -- to limit loans by a holding company mortgage banking subsidiary to the customers of the affiliated broker. Nondepository firms are today permitted to combine ownership of brokerage and mortgage banking subsidiaries. Of course, appropriate supervisory steps would and could be taken to prevent reciprocal lending arrangements or other steps to evade this limitation.

Smaller banks, without mortgage banking subsidiaries, might be put in a difficult competitive position by such a limitation. Consequently, such an approach might be accompanied by an exemption for smaller banks, reasonably related to a relative unavailability of competing brokerage services. It should be possible, for instance, to draw an analogy to provisions of Title VI of the Garn-St Germain Depository Institutions Act of 1982, which permits bank holding companies to offer insurance brokerage services where they would otherwise be impermissible if their consolidated assets were \$50 million or less, or in towns of under 5,000, provided a brokerage affiliate is required to permit or encourage a home purchaser to explore other possible sources of credit.

Technology is providing both independent brokers and those now associated with financial and retail conglomerates

with almost instant access to an array of providers of mortgage credit, enabling their customers to compare terms and conditions. In these circumstances, real estate brokerage appears to be an area in which bank holding companies can draw on relevant experience, undertake little additional risk (particularly if tie-ins are avoided), and increase competitive outlets.

In my past appearances before this Committee, I have expressed serious concern about the potential risks and conflicts for bank holding companies under the general rubric of "real estate development." Those concerns remain.

Present proposals deal with those risks by limiting the capital a bank holding company could apply to real estate development activities or by prohibiting construction activity -- limitations which should be reinforced by also limiting the leverage of the real estate development subsidiary. I would go further by urging you to consider: (a) confining "real estate development" to passive equity participation in projects or developments managed by others, and (b) limiting bank loans to projects sponsored by affiliates of a bank holding company.

The first change would be consistent with what we understand to be the basic objective of most bank holding companies in the real estate development area -- to participate in the potential benefits accruing only to equity participants in a real estate project. To achieve this goal, the rather broad scope of the authorization for real estate development activities contained in FIDA or S. 2181 could well be narrower; for example, participation could be confined to investment vehicles such as nonvoting common stock, preferred stock, or limited partnership interests.

Some of those testifying have expressed concern about the competitive and risk implications of a bank, as lender, participating in a project in which an affiliate has an equity interest. They suggest that a bank in those circumstances will be more willing to extend credit and to carry a weaker credit longer to one of its "own" projects, and perhaps be less willing to extend credit to competing projects, than if no equity interest is involved. To deal with this situation, it might be useful to provide the Board with clear discretionary authority to impose an aggregate or particular limitation on loans by a bank to projects in which a bank real estate affiliate is an equity participant.

(c) Insurance Brokerage and Underwriting

Insurance brokerage by bank holding companies, as is the case with real estate brokerage, does not involve major

issues of risk; rather the focus of the testimony has been on assuring competitive equity between bank affiliated brokers and independent distributors of insurance products. Thrift institutions already have unlimited authority to engage in insurance brokerage, and the broadening of this activity for bank holding companies should provide competitive benefits so long as abuse of the bank relationship is avoided.

S. 2181, in Section 107, contains a number of new provisions that attempt to reduce tying and competitive inequity problems. It would, for example, require banks to inform their customers of the availability of insurance products elsewhere, allow customers purchasing insurance products from bank holding subsidiaries an adequate opportunity to reject their contracts, and prohibit banks and their holding companies from offering insurance until the customer is given a commitment that credit will be extended. It does not seem practically feasible to go much further in this area without destroying completely the ability of holding company organizations to participate in this activity. We would, however, suggest that to the extent Congress deems these provisions necessary when financial institutions sell insurance, they should also be applied to thrift institutions and their holding companies, which are permitted to broker insurance without restrictions such as contained in Title VI of the Garn-St Germain Act.

Consideration could also be given to possible approaches for phasing in greater bank participation in the Insurance brokerage area. Again, it might be useful to build upon Title VI of the Garn-St Germain Act, which permits bank holding company participation in insurance brokerage activities in cases where the holding company's consolidated assets are \$50 million or less, in towns of 5,000 or less, or otherwise where the holding company demonstrates that existing insurance agency facilities are inadequate. For instance, those limitations might be gradually increased by some amount over time up to a limit, which would provide an occasion for further Congressional review.

If bank holding companies are permitted to engage in underwriting, careful attention will have to be given to containing risk, avoiding concentration of resources and more subtle conflicts of interest. For example, there may be particular lines of insurance underwriting that raise issues of risk that require special safeguards and limitations on such matters as amount of capital investment. Moreover, I have earlier suggested that banks not be permitted to lend to companies in which their holding company affiliates had very substantial equity interests.

In order to limit the potential for concentration of resources associated with large bank holding companies acquiring large insurance firms or vice versa, S. 2121 would

limit bank holding company investment in nonbanking activities to not more than 25% of the holding company's capital if the holding company's consolidated assets amount to more than 0.3% of total domestic deposits. However, our review of the data indicates that this test does not effectively limit the ability of some of the largest bank holding companies to acquire control of some of the largest insurance companies.

I recognize that our attempt to devise a numerical test of that kind must be arbitrary at the margin. However, an alternative approach could be to provide specific criteria on the size of bank holding company participation in insurance underwriting and insurance underwriter participation in banking. This could be done by requiring that bank holding companies enter insurance underwriting de novo or through relatively small acquisitions. Similarly, insurance underwriters would also be confined to de novo or foothold acquisition of banks. This approach would deal with the concentration issues and it would provide time for the participants, the Board, and state insurance regulators to gain experience in dealing with combined insurance and banking entities.

An alternative approach would be to expand bank holding company participation in insurance underwriting in directions that flow naturally from existing bank functions. For example, it would seem appropriate for bank holding

companies to participate in insuring or guaranteeing the credit risk in home mortgages and in real estate title insurance. Dollar limits on individual credit-related property and casualty insurance policies underwritten by bank holding company nonbank affiliates could be lifted. After some experience, Congress could then consider other areas of insurance underwriting activity that might be appropriate as part of a gradual evolution of bank holding company insurance underwriting.

(d) Ownership of Thrifts

S. 2181 specifically permits bank holding companies to acquire FSLIC insured thrifts, subject to the same kind of limitations on interstate acquisitions as are written in the Douglas Amendment and the same kind of branching restrictions on the acquired thrift as are contained in the McFadden Act. The Board has supported bank holding company acquisition of thrift institutions as a reasonable extension of their presently authorized scope of activities. We recognize, however, that acquisition of thrifts by bank holding companies on an interstate basis may, in some situations, not be fully consistent with the prohibition on interstate banking contained in the Douglas Amendment. The Board has indicated its views that Congress should, in the future, address the overall question of interstate banking in comprehensive legislation. However, pending Congressional action on the overall question,

the Board believes it is reasonable to incorporate Douglas and McFadden type limitations on thrift acquisitions that are proposed in S. 2181.

(e) Financial Services

S. 2181 authorizes holding companies to engage in "services of a financial nature." This provision provides useful flexibility for the Board to deal with uncertain and unknown circumstances in the future. We recommend its inclusion in legislation.

The decision of Congress on the inclusion or exclusion of the various activities that have been discussed above will provide some guidance on the intended scope of this provision. Additional guidance would be desirable with respect to other activities that the Congress might consider to be within the scope of this authorization.

V. Activities of State-Chartered Banks

Much concern has been expressed about possible authorizations to state-chartered banks of new authorities to conduct nonbanking businesses that would not be permitted to bank holding companies under present or new federal laws. It is reasonable to ask the question whether it makes sense for the Congress to work out carefully balanced arrangements for the conduct of nonbanking activities of bank holding companies only to see far different and inconsistent arrangements established for state banks under state law.

Some states have adopted, and others are considering, legislation to authorize state-chartered banks to engage in insurance, securities, and real estate development activities; and others have authorized state-chartered thrifts to engage in virtually unlimited activities. Last year, South Dakota authorized state-chartered banks to engage in insurance-related activities essentially in all of the states of the Union except South Dakota. The states are motivated in part by a desire to make their financial institutions competitive with those in other states and in part by a desire to obtain new employment and revenues -- inevitably at the expense of others. As the process gains momentum, more and more states will feel themselves forced, in self-defense, to take similar steps. The threat is obvious -- any sense of Congressional or federal control over the evolution of the banking and financial system will be lost.

S. 2181 attempts to deal with this problem by requiring that insurance activities be conducted in the state and outside the state on the same terms. S. 2134 would go considerably further by requiring that states may only authorize activities for state-chartered banks to be conducted within the state and for residents of that state.

In the light of current developments, it now appears desirable to go somewhat further than the provisions of S. 2134, while still maintaining flexibility for state

experimentation and innovation. In balancing these considerations, perhaps it is desirable to distinguish between those activities that Congress may decide to prohibit or limit for banking organizations because of safety and soundness problems, and those that arise from conflicts of interest that are particularly important for the protection of local customers.

For example, if Congress reaffirms its decision to exclude banking organizations from participating in underwriting corporate debt and equity, and limits the participation of these organizations in real estate development, it would not seem to be desirable for the states to have the authority to overrule the judgment of Congress and expose the insured depository system to the greater risks of these activities. On the other hand, if Congress decides not to authorize real estate or insurance brokerage because of reasons of consumer protection and competitive equity, it would not seem inconsistent with the federal interests if state legislatures authorize banking organizations to participate in these activities within the confines of their own state. Here the state may be in the best position to make the judgment about what is necessary to protect local customers and local interests.

Thus, the balance between federal and state interest could be struck as follows: states may not authorize

activities that Congress has ruled out of bounds for safety and soundness reasons; the states may optionally authorize other activities but only if they are conducted within their borders. We would be prepared to assist the Committee in drafting such a provision.

Other Provisions of S. 2181

My comments today have focused only on Title I of S. 2181 as I believe it is that Title that requires the priority attention of the Congress. Detailed comments on a number of other Titles are contained in Appendices to be submitted separately for the record. Before my concluding remarks, I would like to comment specifically on the provisions contained in Title X on regional interstate banking.

Title X provides specific authority, for a five-year period, for states to authorize regional interstate banking acquisitions. Such legislation would presumably resolve the question of the constitutionality of regional arrangements that have been authorized in New England and have been proposed in a number of other areas of the country. Yesterday, the Board approved two bank holding company mergers under the reciprocal arrangements of Massachusetts and Connecticut. Although there is a strong argument that these state laws are not consistent with the prohibitions against discriminatory burdens on interstate commerce established by the Commerce Clause of the Constitution, there is an absence of clear and unequivocal

evidence to that effect. Consequently, the Board proceeded on the assumption of constitutionality and applied the criteria of the Bank Holding Company Act. But plainly, the differing constitutional interpretations raised by parties to merger applications demonstrates the need for Congressional action to clarify this issue at this time.

We believe this is all the more important because of our concern about the permanent establishment of regional banking areas. If Congress should decide to endorse regional arrangements, in our view it would be desirable to limit them to a transitional period. We would also urge you to consider the interstate banking question more broadly at an early date, once the powers issues are settled.

Conclusion

I cannot emphasize strongly enough the urgent need for definitive Congressional action on the legislation now before you during the current session. Decisions cannot be postponed -- the failure to act only means that others have acted and will continue to act, to markedly restructure the financial system without the participation of the Congress. These actions, arising out of market initiatives, state legislation, court decisions and new federal regulatory rules, are pushing at the outer boundaries of the legal framework established by Congress for the banking and financial systems. In my judgment, they are pushing beyond the basic policies

established by the Congress in setting out a broad distinction between banking and commerce.

I am not speaking about theoretical concerns. The policies of the Bank Holding Company Act against excessive risk, conflicts of interest, impartiality in the credit-granting process, and concentration of resources have long been considered essential parts of our financial system. They are now being undermined by a haphazard pattern of inter-industry and interstate acquisitions and by new combinations of banking, securities, insurance and commercial products.

The Bank Holding Company and Glass-Steagall Acts were intended to prevent combinations of firms that underwrite securities and take deposits. Yet today there are 32 securities firms that own so-called nonbank banks which can perform many of the essential functions of banks. Court and regulatory decisions are opening new avenues for bank holding companies to undertake securities functions without clear legislative guidance.

The Bank Holding Company Act was intended to prevent combinations of commercial or industrial firms from owning banks, yet today there are retailers, diversified industrial-commercial conglomerates, and insurance firms that own either nonbank banks or thrifts with banking powers.

The states are rapidly considering and adopting legislation granting state-chartered banks powers that, in some cases, have not even been contemplated under federal law for banks and bank holding companies, in large part reflecting inter-state competition for jobs and tax revenue rather than any judgment of the national interest in a stable banking structure.

The federal financial regulators are also pressing against the outer boundaries of their delegated authority. The Board has adopted the broadest definition of the term bank it felt feasible under existing law in an effort to carry out what it believes to be Congressional intent and to preserve the ability of Congress to act without being faced with a fait accompli. That action is being challenged in the courts with, thus far, unfavorable results. The SEC has before it a proposal to consider banks as broker-dealers when they engage in discount brokerage, despite the exclusion of banks from the securities laws because of the comprehensive system of bank regulation. Under existing law, the FDIC is considering the question of whether state non-member banks should be authorized by regulation to underwrite corporate debt and equity, despite long-presumed Congressional intent to separate commercial banking and corporate underwriting. The Comptroller has before it a well-known proposal to authorize a family of "nonbank" national banks in 25 states. We have been compelled to approve

the establishment by a New York bank holding company of a nonbank bank in Florida, which would take demand deposits but not make commercial loans as we have broadly defined them.

As things now stand, many of these specific issues will be decided on a case-by-case basis in the courts -- but we cannot expect those decisions to be guided by a policy perspective on how the financial system as a whole should evolve. That, in the end, is the task of the legislature, not of the courts which must struggle to adapt today's circumstances to yesterday's laws. Until all of us -- the regulators, the banks, other competing industries, and the courts -- have more Congressional guidance, every new decision will be subject to legal challenge.

If Congress does not decide, decisions will still be made. But they seem certain to be conflicting, and not fit into a coherent whole. One clear risk is that the overriding public interest in a strong, stable, and competitive financial system will be lost.

The time for action is here. Many elements of comprehensive legislation are already broadly accepted. I believe the remaining elements and the necessary compromises can be put together soon. I hope and believe this Committee can be the vehicle for moving ahead.

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ATTACHMENT II

AMENDMENTS TO THE DEFINITION OF BANK
IN THE BANK HOLDING COMPANY ACT

1. Definition of Commercial Loan
2. Trust Company Exemption
3. Limits on Demand Deposit Taking and Commercial Lending of Grandfathered Nonbank Banks
4. Limits on Activities and Geographic Expansion of Grandfathered Nonbank Banks
5. Treatment of FDIC Insured Savings Banks
6. Requirement for Federal Insurance for Bank Holding Company Subsidiary Banks

AMENDMENTS REGARDING STATE CHARTERED
DEPOSITORY INSTITUTIONS

1. Amendment Regarding Banks
2. Amendment Regarding Thrifts

AMENDMENTS TO THE QUALIFIED THRIFT LENDER
PROVISIONS OF THE SAVINGS & LOAN
HOLDING COMPANY ACT AMENDMENTS

1. Definition of Qualified Thrift Lender
2. Prohibition on Marketing by an Affiliate of an Insured Thrift's Deposits

OTHER AMENDMENTS

1. Amendment Regarding Mortgage-backed Securities
2. Amendment Regarding Leasing Authority of National Banks

Amendment to Definition of
Commercial Loan in S. 2851

Amend section 104(a)(3)(k) to read as follows:

"(k) The term 'commercial loan' means any loan other than a loan the proceeds of which are used for personal, family, household, or charitable purposes, and includes broker call loans, loans secured by real estate the proceeds of which are used for other than personal, household, family, or charitable purposes, and the purchase of retail installment loans, accounts receivable, and commercial paper. Commercial loans shall not include the purchase of certificates of deposit, bankers acceptances, or obligations of the United States or local and State governments or agencies or instrumentalities thereof, the sale of Federal funds, or the deposit of interest bearing funds."

Explanation

S. 2851 defines commercial loan to exclude a number of instruments that traditionally have been regarded as commercial loans, including commercial real estate loans and the purchase of retail installment loans, accounts receivable, and commercial paper. The bill also includes a definition of "engaged in the business of making commercial loans" under which an institution is not regarded as engaged in the business of commercial lending if it devotes less than 10 percent of its assets to commercial loans. As so structured, the definition

such institutions from the Bank Holding Company Act if they are and have been privately insured since the date of enactment of the bill. The exemption would terminate if the institution undergoes a change in control by a company engaged in activities that are impermissible for bank holding companies under the BHC Act.

This amendment is designed to exempt those nonfederally insured institutions that accept transaction accounts and that would be covered as banks under the Bank Holding Company Act by virtue of the commercial lending definition contained in the previous proposed amendment to S. 2851. This amendment is necessary only if proposed commercial lending amendment is adopted.

Amendment to S. 2851 to Limit
Trust Company Exception

Amend section 104(a)(1)(v) to read as follows:

"(c) 'Bank' means . . .

(v) any institution that functions solely in a trust or fiduciary capacity, such as described in subsection (a) of the first section of the Act of September 28, 1962 (12 U.S.C. 92a(a)), provided that--

(I) all or substantially all of the deposits of such institution shall be in trust funds and received in a bona fide trust capacity, as determined by the Board, and solely as an incident to bona fide trust services;

(II) any deposits of the institution shall not be offered or marketed by or through a company that controls the institution or any affiliate of such company;

(III) the institution does not offer demand deposits or deposits subject to withdrawal by check or any other similar means;

(IV) the institution does not obtain from Federal Reserve Banks services specified in section 11A of the Federal Reserve Act and does not exercise discount and borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act; and

(V) all or substantially all of the income of the institution is derived from trust, custodial or related fiduciary service fees and not from lending or investing of deposits; . . ."

Explanation

This amendment ensures that the proposed trust company exemption from the bank definition is limited to institutions that function as fiduciaries. The amendment limits the trust company exemption from the bank definition to institutions that do not accept checking accounts, market deposits through affiliates, or make use of Federal Reserve services and that derive all or substantially all of their income from fiduciary activities.

Amendments to Grandfather Provision
in S. 2851 to Limit Demand Deposit Taking and Commercial
Lending by Grandfathered Nonbank Banks

Amend clause (ii) in the second and third sentences of section 104(c)(2) to read as follows:

" , such institution commences accepting demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties and engages in the business of making commercial loans, "

Explanation

This amendment would prevent a grandfathered nonbank bank that engages in the business of making commercial loans from also accepting NOW accounts.

Amendments to Grandfather Provision in
S. 2851 to Limit Geographic Expansion of, and to Prevent
Joint Marketing Operations By, Grandfathered Nonbank Banks

Amend section 164(c)(2), to delete the "or" before "(iii)" in the second and third sentences, and add in the second and third sentences before the periods the following:

" , (iv) such institution increases the number of locations from which it conducted its activities on June 27, 1984," or

"(v) such institution offers or markets the products or services of any affiliate engaged in activities not permitted for bank holding companies under paragraph (8) of subsection (c) of this section or the products and services of the institution are offered to or marketed through any affiliate engaged in activities not permitted for bank holding companies under paragraph (8) of subsection (c) of this section"

Explanation

This amendment would prevent a grandfathered nonbank bank from expanding geographically. The amendment would also prevent the grandfathered nonbank bank from being operated together with affiliates engaged in impermissible nonbanking activities. This joint marketing limitation covers the marketing or offering of the nonbank bank's products and services through such an affiliate or the offering or marketing of the affiliate's products and services through the nonbank bank.

Amendments to S. 2851 to Limit the Grandfather
Rights of FDIC Insured State Savings Banks

Amend the first sentence of section 104(i) as follows:

"(f) Notwithstanding any other provision of this Act, a savings bank, as defined in section 3(g) of the Federal Deposit Insurance Act, which is chartered under state law, and which is or becomes a subsidiary of a bank holding company may engage, directly or through an affiliate, in any activity which it was permitted to conduct as a state-chartered savings bank, pursuant to express, incidental, or implied powers under state statute or regulation or under judicial interpretation of state law on June 27, 1984. . . ."

Explanation

The bill currently provides open-ended grandfather rights to state-chartered FDIC insured savings banks to engage in any nonbanking activities that are currently authorized for the bank under state law or that may in the future be authorized for state savings banks. This amendment limits such grandfather rights to those activities performed by the savings bank on June 27, 1984.

Amendment to Require Federal Deposit Insurance
for Bank Holding Company Subsidiary Banks

Delete section 104(k) of S. 2851.

Explanation

Section 3(e) of the Bank Holding Company Act currently provides that every bank that is a subsidiary of a bank holding company shall become and remain an FDIC insured bank. S. 2851 would amend this requirement to permit the bank to insure its deposits under state law in lieu of federal deposit insurance. This amendment would maintain the current requirement for FDIC insurance for all subsidiary banks of bank holding companies.

Amendment to S. 2851 to Limit In-State Activities of
Holding Company Bank Subsidiaries

Amend section 104(g) by deleting the word "and" before the numeral (2) and by adding before the period at the end thereof the following:

", and (3) a State chartered bank subsidiary of a bank holding company may not engage in, or acquire the shares of a company engaged in, any activity within the state where the bank is chartered that the Board has determined, after notice and opportunity for the submission of written views, to be unsafe or unsound for banks"

Explanation

S. 2851 prohibits state chartered banks that are owned by bank holding companies from engaging outside of the state in which the bank is chartered in nonbanking activities that are prohibited for bank holding companies under the Bank Holding Company Act. S. 2851 would, however, permit state banks to engage in such prohibited nonbanking activities within the authorizing state. This amendment would allow state banks to engage in nonbanking activities authorized by state law within the state unless the activity is determined by the Board to be unsafe or unsound for banks.

Amendment to S. 2851 to Limit Activities
of Insured Institutions

Amend section 107 of S. 2851 by adding the following new paragraph (h):

"(h) Section 408 of the National Housing Act (12 U.S.C. 1730a) is amended by adding the following new paragraph:

"(o) Notwithstanding any other provision of law, an insured institution and any subsidiary thereof shall not engage in (1) any activity outside of the state in which the institution is chartered unless the activity is permissible for a savings and loan holding company under paragraph (2) of subsection (c) of this section or (2) any activity within the state in which the institution is chartered that the Corporation has determined, after notice and an opportunity for the submission of written views, to be unsafe or unsound for insured institutions. Nothing in this subsection shall prohibit an insured institution from engaging in any activity permitted by statute for a Federal savings and loan association or Federal savings bank.

Explanation

S. 2851 prohibits a subsidiary bank of a bank holding company from engaging outside of the bank's home state in impermissible nonbanking activities. This amendment would amend the Savings & Loan Holding Company Amendments of 1967 to prohibit an FSLIC insured thrift institution from engaging outside of the thrift's home state in nonbanking activities

that are not permissible for a multiple savings and loan holding company.

In addition, this amendment provides that insured institutions may not engage within their home states in nonbanking activities that the Federal Savings and Loan Insurance Corporation determines, after notice, to be unsafe and unsound for insured institutions. A similar amendment is proposed for subsidiary banks of bank holding companies.

Amendments to Qualified
Thrift Lender Test in S. 2851

Amend section 107(b) to read as follows:

"(c) * * *

(4) * * *

"(B) A qualified thrift lender is any insured institution that, as determined by the Corporation, has an aggregate of not less than 65 per centum of its assets (including investments made by any subsidiary of such institution) invested in loans or securities related to domestic residential real estate or manufactured housing, property used by an institution in the conduct of its business, and liquid assets of the type and in such amounts as are required to be maintained under section 5A of the Federal Home Loan Bank Act, and thereafter remains at or above such percentage on an average basis in three out of every four quarters. For the ten-year period following the date of enactment of the Financial Services Competitive Equity Act, a qualified thrift lender shall also include any insured institution that was chartered prior to October 15, 1982, as a savings bank under state law if the Corporation determines that the insured institution does not decrease the percentage of its assets invested in investments described in this clause below the percentage it held on such effective date, and increases such percentage of its assets by an amount at least equal to the following percentages of the difference between 65 per centum and the percentage of its assets so invested on the date

of enactment of this paragraph within the following time periods from the date of enactment of this paragraph:

- (I) within 2-1/2 years, 25 percent;
- (II) within 5 years, 50 percent; and
- (III) within 7-1/2 years, 75 percent. . . ."

Explanation

This amendment would raise the qualifying asset test in S. 2851 from 60 percent to 65 percent, exclude mortgage originations and equity positions as qualifying assets, limit qualifying liquid assets to the amounts required by the FHLBB for liquidity purposes, and delete the provision allowing compliance with the asset test in only two out of every three years. An institution thus would be required to devote a significant portion of its assets to home lending in order to qualify as a qualified thrift lender.

Amendment to S. 2851 to Prevent Federally-Insured
Thrifts From Engaging in Joint Marketing Operations
with Holding Company Affiliates

Amend section 107(c) to insert the following at the end thereof:

"(4) A new subsection (d)(1)(G) shall be added to read as follows:

"(G) offer or market the products or services of any affiliate that is not a qualified thrift lender nor offer or market its own products or services through any affiliate that is not a qualified thrift lender.".

Explanation

This amendment would prevent joint marketing operations between FSLIC insured thrifts and their affiliates if such affiliates engage in activities impermissible for a bank holding company. The amendment thus would subject thrifts to the same limitation that applies to banks in furtherance of the policy of separating banking and commerce.

Amendment to S. 2851 Regarding
Mortgage-backed Securities

Amend the first sentence of section 104(e)(3) of S. 2851 by inserting after the words "promisory notes secured by" the words "one-to-four family".

Explanation

This amendment limits underwriting of mortgage-backed securities to 1-4 family real estate mortgages.

Amendment to S. 2851 Regarding
Leasing Authority of National Banks

Strike section 111 of the bill.

Explanation

Non-full payout leasing raises significant issues of safety and soundness that have not been adequately evaluated.

ATTACHMENT III

STATEMENT ON INTERSTATE BANKING

The basic Federal branch banking law, the McFadden Act of 1927, has not been amended in any substantive manner since 1933. The law effectively prohibits national banks from branching interstate by limiting each national bank to branching only within its home state, subject within that state to any branching restrictions imposed by that state on state-chartered banks. The Douglas amendment to the Bank Holding Company Act of 1956 prohibits interstate expansion by means of a bank holding company acquiring banks in another state unless such acquisitions are explicitly authorized by that state.

In spite of the statutory McFadden and Douglas prohibitions, de facto there has been a large and increasing amount of interstate banking in recent years. Some of that has taken place through avenues specifically permitted by law.

According to a study by the Federal Reserve Bank of Atlanta, U.S. bank holding companies in 1982 had 202 loan production offices and 143 internationally oriented Edge Act Corporations operating outside the parent's home state; foreign banking organizations had another 254 banking offices outside their home state. There are probably more today. More important are the variety of finance companies, mortgage companies, industrial banks and other offices with at least partial banking capabilities operating outside the holding company's home state and many more exist now.

Technological advances are also providing large opportunities for banks to expand geographically without brick and mortar offices. By joining ATM networks, banks in some cases have been able to reach out to existing or new customers over state lines. Looking ahead, banking through home computers would be difficult to confine within a state's boundary. But even without exotic technology, the relative speed and simplicity of communications and transportation today makes it much easier, particularly on the deposit side, to conduct banking at a distance. Large businesses routinely "sweep" deposits into "concentration accounts" at selected banks. The combinations of print and broadcast advertising, 800 number telephone lines, deposit brokerage, and efficient clearing mechanisms mean that the day of rather insulated local deposit markets are gone. On the loan side, nationwide credit cards are available to customers throughout the country.

The substantial number of "nonbank bank" applications by bank holding companies, stretching the fabric of existing law, is one indication of the strength and depth of some banks' desires to operate over a wider geographic area. The pressures toward interstate operations arise from a number of sources. Competition from non-depository businesses that can and do provide financial services -- including money market accounts and other bank-like services -- through interstate networks is strong and pervasive. Thrift institutions, which have no statutory bar to interstate branching, offer interstate facilities in a significant number of cases. Moreover, banks in slower growing areas naturally want to participate in more rapidly expanding regions. Florida alone, for instance, has attracted about 20 percent of all nonbank bank applications by bank holding companies.

A number of relatively large banks that nevertheless rank well below the largest money center institutions in size apparently feel, with some urgency, that a stronger competitive position in national and international markets requires a larger size than can reasonably be attained within the boundaries of a singly state. Some of the largest banks, conversely, urgently wish to attain a wider and more stable base of "retail" deposits and to expand their consumer lending. At the other end of the spectrum, there are small banks concerned about their ability to compete effectively without being able to combine with others in a natural market area that may extend over state boundaries.

Resistance to interstate banking for a variety of reasons -- including a desire of many banks to continue as independent institutions -- clearly remains strong. But the pressures for change are apparent in initiatives by a number of states toward more interstate banking. The growing number of regional interstate banking arrangements is the most important reflection of that change in attitude. Today 14 states have enacted laws permitting reciprocal entry by bank affiliates of bank holding companies headquartered in states within a designated region; 12 more states are actively considering such arrangements. Four states allow entry from any other state, three without and one with reciprocity. These liberalized approaches toward interstate banking over recent years suggest a significant change in thinking since the McFadden act and the Douglas amendment were enacted.^{1/}

^{1/} Attached are a chart showing interstate banking regions and a table listing the status of interstate banking legislation in the 50 states and the District of Columbia.

Substantive Issues in Interstate Banking

The time has come to review and clarify national policy toward interstate banking, recognizing the economic and competitive pressures driving toward liberalization of present restrictions, while also protecting the safety and efficiency of the banking system, preventing undue concentration of economic resources, and assuring benefits to the users of banking services.

One continuing objective of public policy is to assure competition in banking, as in other industries. Ordinarily, we would not expect that competition would be promoted by confining an industry to a singly geographic market or a single state. Indeed, we rely on the ability of additional firms to enter markets as a competitive force leading to the best possible products at least cost. Moreover, existing anti-trust law appears to provide considerable protection against local markets becoming non-competitive as the result of entry of larger organizations.

Available empirical studies do not suggest that large states with large banks and statewide branching are experiencing increasing concentration of local markets. The presumption that restrictions on entry into particular markets imply some loss of competitive vigor, unless overridden by other considerations of public policy, suggests that some liberalization of interstate banking is appropriate. That presumption had added force in an environment in which other large financial service firms are able to operate nationwide, exploiting what economies of scale in technology or marketing may be available. In effect, those firms may now be in a position to skim off profitable areas of business from banks committed to providing a full range of banking services.

Historically, a counter-argument to interstate banking has been a strong antipathy to concentration of economic power, particularly in the banking system, and a desire to maintain banking resources in significant measure under control of local banks, knowledgeable about the needs and circumstances of smaller businesses and individuals.

Experience in states with large banks and statewide branching suggests that these are not questions of "either-or." Attachments I and II provide a brief analysis of experience in two of our largest states, one of which has had statewide branching for decades and the other of which has permitted statewide operations only since 1976. In both cases, large numbers of relatively small independent banks remain. In California, a rapidly growing state, new banks are being formed

in relatively large numbers; in New York, a state that is growing more slowly, relatively few new banks have been formed, but the number of small independent banks (i.e., under \$100 million) has dropped only modestly since statewide branching was permitted. In both states, the competitive environment appears healthy, with the consumer and businessman able to choose between some of the largest banking institutions in the world and small locally oriented banks. Should banks be permitted to expand interstate more freely, we would anticipate similar patterns to prevail.

A rush to expand geographically could pose certain risks -- temptations to pay exceptionally high prices and to leverage capital, to spread management thin, and to enter into new types of lending or operations where experience may be limited. These risks can be dealt with through normal supervisory processes, particularly in evaluating financial and managerial factors with respect to applications. In particular, a banking organization planning sizable expansion programs should be able to demonstrate its ability to maintain fully adequate capital and liquidity positions, to avoid excessive use of goodwill on its balance sheet, and to provide capable management for acquired institutions. The risks -- actual and potential -- from expansion into new banking markets are typically more identifiable, and often less, than those posed by entry into new nonbanking activities where bank management may have little or no experience.

Concentration

Viewed from a national perspective, restrictions on interstate banking have been effective in forestalling large concentrations of domestic banking resources, at least by the standards of other countries. The 10 largest banking organizations control only about 20 percent of all domestic banking assets, and the 100 largest only a little more than half.

Presumably, concentration ratios would tend to rise with interstate banking, quite significantly so if such activity is unrestricted. At the same time, the California and New York experience referred to earlier suggests the process would stop very far short of the concentration of institutions common in other countries, with thousands of independent organizations remaining.

A variety of safeguards should be included in legislation liberalizing interstate banking to encourage continuing diversification of banking resources. Taken alone, anti-trust laws -- focused on the market shares of competitors

in particular markets -- do not appear fully responsive to that need. Essentially, those laws as applied to banking make little distinction between the overall size of organizations competing in particular markets, but rather focus on the size of their presence in a single market alone. Consequently, those laws might be consistent with considerably greater concentration, measured on a national or regional basis, than would be desirable.

Two kinds of limitations might be taken to forestall any substantial risk of excessive concentration. The approaches are not mutually exclusive and would be complementary. Both would, at the margin, involve essentially arbitrary judgments, for they would envisage a simple quantitative measure of relative size. But, by responding directly and logically to the concerns about concentration, they would provide a more coherent approach than the present "system" of implicitly relying on an almost total prohibition on interstate acquisition as an indirect means of controlling concentration levels.

The first approach would envisage limitations of the largest banking institutions acquiring other banks. For instance, the very largest holding companies in terms of domestic banking assets (or depository institution assets) -- say the top twenty-five -- might be prohibited from merging with each other. In addition, banks could be prohibited from obtaining through acquisition more than some fixed share of the nationwide total of such assets, although *de novo* or relatively small acquisitions in other states could be permitted.

The second approach would permit, or even encourage, states to set limitations on the proportion of banking assets (or depository institution assets) within their own borders that could be acquired through acquisitions or mergers of institutions of significant size. Specifically, such acquisitions could be denied if the resultant institution would hold more than, for example, 15 or 20 percent of a state's banking assets. Any such rule should be nondiscriminatory between in-state and out-of-state banking organizations.

Of course, rules implementing these approaches would have to be carefully drawn to avoid anomalous results. The important point is that the national and state-wide concentration limits be fully observed.

Exceptions to these limitations should be permitted for failing institutions. Indeed, in light of the remaining strains evident in some sectors of the thrift and banking industries, the emergency arrangements for failing institutions in the Garn-St Germain Act should be extended. They should be

liberalized in two ways: by not requiring that an institution actually be "closed" to qualify for emergency treatment, and by reducing or eliminating the \$500 million size cut-off in the Act.

The Dual Banking System

Interstate banking, by its nature, has implications for the dual banking system. Indeed, it is difficult to conceive of a system of interstate branching that would enable state law and supervision to govern the operations of banks in sister states. Consequently, interstate branching could well lead to a massive expansion of the national banking system.

If interstate banking operations are instead generally confined to separately incorporated and chartered components of a holding company, particular states could maintain authority over the in-state operations of the holding company. Moreover, there would be opportunity for a greater degree of local control. For those reasons, a requirement that interstate acquisitions generally take the form of a holding company affiliate appears to fit more naturally our banking traditions, at least over a long transitional period to a fully developed interstate banking environment.

A Possible Policy Approach

Various approaches toward interstate banking have been proposed over the years, ranging from modest changes in existing arrangements to nationwide branching. For instance, possible transitional approaches well short of nationwide banking include:

- (1) Branching throughout metropolitan areas that extend across state lines, of which there are 35 at present.
- (2) Expansion into contiguous states.
- (3) Expansion de novo or by acquisition, into any metropolitan area above a minimum size.
- (4) Encouragement of reciprocal arrangements among states.
- (5) Interstate banking limited to de novo operations or small acquisitions (conversely, some have proposed limiting or prohibiting small acquisitions in the interest of maintaining local banks).
- (6) Regional arrangements.

Each of those approaches (and any others that could be developed) has particular strengths and weaknesses; each could be debated. However, much of the recent thinking in states, and within the banking community, has focused largely on the last of those options -- regional arrangements. Consequently, it would be useful to focus on that approach as a point of departure.

An advantage of regional arrangements seen by many is the opportunity for regional organizations to reach a size necessary for an effective national or international presence, and then to become more effective competitors of the largest banking institutions in all phases of banking.

However, the approach suffers from some clear weaknesses. The regions may be defined in a discriminatory way, aimed at encouraging particular combinations of banks and excluding others, without clear and objective rationale. Specifically, some proposals appear to be driven by a desire to exclude New York and California banks, or simply large money center banks. By their nature, sizable regional arrangements would permit combinations of banks long distances (and several states) apart, without permitting even limited operations in some contiguous states. Metropolitan areas might be left, in a banking sense, bifurcated. Viewed as a permanent arrangement, regional compacts would tend to Balkanize banking, with a tendency toward regional concentrations.

Because of these potential weaknesses, a federal framework is required for regional arrangements. For example, such weaknesses can be substantially ameliorated if states entering into such regional arrangements were also required after relatively few years -- say three -- to permit reciprocal entry by banks in any state that has enacted a regional arrangement or otherwise provides for entry of banks of any other states.^{2/}

^{2/} Regional arrangements are the subject of a constitutional challenge that is now before the Supreme court. A federal framework, such as suggested above, could be put in place if the Supreme Court sustains regional arrangements or even if the court were to find them unconstitutional on grounds of violation of commerce or compact clause requirements. However, if the court were to find that such arrangements violate the equal protection clause, there would be a substantial question whether such arrangements could be permitted even if sanctioned by Federal law. See Exhibit C.

In this approach, any state, if it so chose, could continue entirely to "opt out" of full interstate banking. But, if it chose to enter into a regional arrangement, it would also have to be prepared to consider those arrangements as a transitional approach toward a broader arrangement encompassing all states willing to provide reciprocal privileges.

As suggested above, all interstate acquisitions would be subject to federal limitations designed to protect against undue concentration, and states would be able to limit the proportion of their banking assets acquired by a single banking organization. In the first stages at least, these interstate operations should be undertaken by means of separately incorporated units of a holding company rather than by direct branches.

The number of states that ultimately might wish to enter into regional (or nationwide) arrangements within this broad framework must, for the time being, remain unknown. Consequently, the possibility would exist that little progress would be made toward interstate banking, even for limited operations within metropolitan areas. Yet, the status quo is hardly satisfactory, and the legitimate pressures toward interstate operations that have impelled "nonbank banks" would continue to seek "unnatural" channels. Consequently, with due notice, the Congress should authorize interstate branching within metropolitan areas and for neighboring areas of contiguous states.

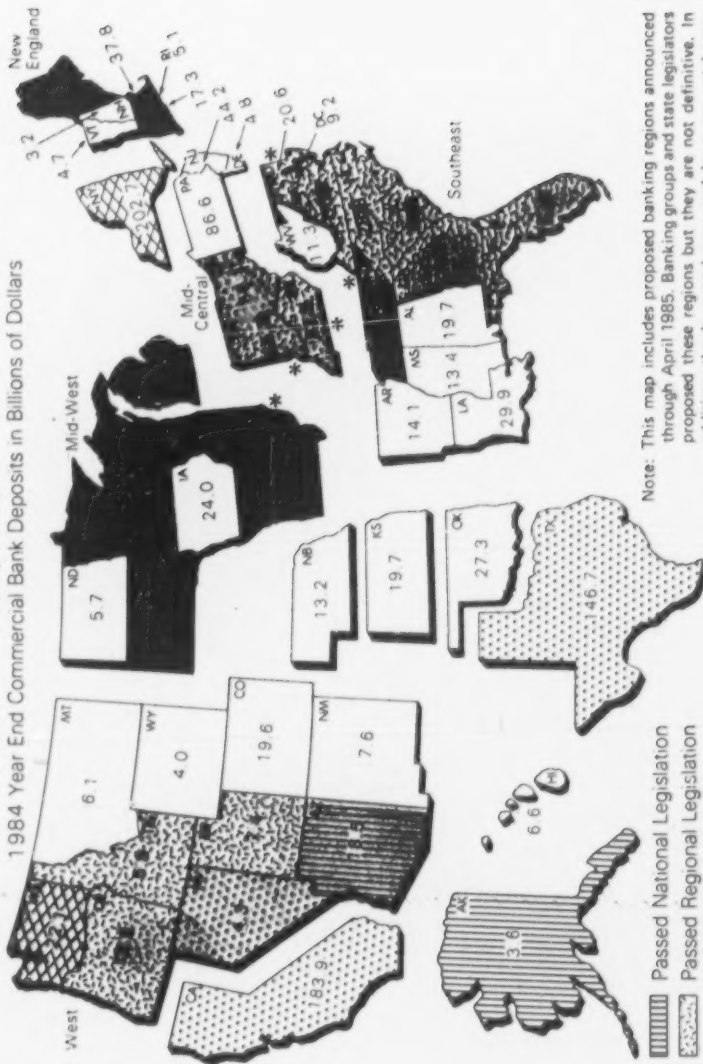
Conclusion

The need for Congressional action is urgent to guide the orderly evolution of the banking system and to reaffirm certain basic principles that have guided the banking and financial systems, adapting them to present circumstances. Markets will continue to respond and change will take place. The only question is whether that change will take place in a constructive framework of rules established by the Congress after a careful weighing and balancing of the vital public interests that are now before you for review. Taking account of both market forces and recent state initiatives, a comprehensive approach now requires a resolution of the issues involved in interstate expansion.

Principal Interstate Banking Regions Being Considered by the States

(As of April 1985)

1984 Year End Commercial Bank Deposits in Billions of Dollars



Note: This map includes proposed banking regions announced through April 1985. Banking groups and state legislators proposed these regions but they are not definitive. In addition, the laws and proposed laws are not homogeneous. This map does not indicate states with limited purpose, grandfathered or troubled institution laws.

- Passed National Legislation
- Passed Regional Legislation
- Proposed Legislation
- Passed National Reciprocal Legislation
- No Legislation Actively Pending

* Important: See attached notes.

NOTESNEW ENGLAND REGION

Rhode Island's law provides for a "national trigger" under which the regional requirement expires on July 1, 1986, and thereafter acquisitions will be permitted from any state with a reciprocal statute.

SOUTHEAST REGION

The southeastern states that have enacted regional-reciprocal laws differ to some extent in their definitions of the region. For example, the Georgia statute excludes Maryland, West Virginia and Arkansas, while the North Carolina, South Carolina, Florida and Virginia statutes include these states.

MIDCENTRAL REGION

Kentucky has a law which allows interstate acquisitions with its contiguous states with reciprocal agreements. Kentucky has been included and proposed for inclusion in the Southeast region and portions of the Midcentral region. The Kentucky statute contains a national trigger provision under which acquisitions from any state will be permitted on a reciprocal basis after July 15, 1986.

Maryland, Tennessee, Virginia, West Virginia and Washington, D.C. have been included or proposed for inclusion in both the Southeast and portions of the Midcentral regions.

MIDWESTERN REGION

Indiana and Illinois have been proposed for inclusion in portions of both the Midcentral and Midwest regions.

The South Dakota law permits any out-of-state bank holding company to acquire one existing South Dakota bank, but thereafter limits the bank's ability to open additional branches.

WESTERN REGION

The western states that have enacted regional-reciprocal laws differ to some extent in their definitions of the western region. For example, both the Utah and Idaho statutes exclude California, while the Oregon statute includes this state.

The proposed Nevada statute contains a national trigger provision effective January 1, 1989.

Texas has not been proposed for inclusion in any of the regions, but is considering legislation to establish a 10 state region, including certain states in the Western, Southeast, and Midwest regions.

The Washington legislature passed its proposed national reciprocal law on April 19, 1985.

INTERSTATE BANKING LEGISLATION BY STATE
(as of May 1, 1985)

<u>STATE</u>	<u>STATUS OF LEGISLATION</u>	<u>TYPE</u>	<u>REGION (if any)</u>
Alabama	None		
Alaska	Effective	National	All States
Arizona	Effective October 1, 1986	National	All States
Arkansas	Defeated	Regional- Reciprocal	SOUTHEAST (14 States & DC) AL, FL, GA, LA, MD, MS, MO, NC, OK, SC, TN, TX, VA, WV, DC
California	Proposed	National- Reciprocal	
Colorado	None		
Connecticut	Effective	Regional- Reciprocal	NEW ENGLAND (5 States) ME, MA, NH, RI, VT
Delaware	None		
District of Columbia	Proposed	Regional- Reciprocal	SOUTHEAST (11 States) AL, FL, GA, LA, MD, MS, NC, SC, TN, VA, WV
Florida	Effective July 1, 1985	Regional- Reciprocal	SOUTHEAST (11 States & DC) AL, AR, GA, LA, MD, MS, NC, SC, TN, VA, WV, DC
Georgia	Effective July 1, 1985	Regional- Reciprocal	SOUTHEAST (9 States) AL, FL, KY, LA, MS, NC, SC, TN, VA
Hawaii	None		
Idaho	Effective July 1, 1985	Regional- Reciprocal	WEST (6 States) WA, OR, MT, NV, UT, WY

<u>STATE</u>	<u>STATUS OF LEGISLATION</u>	<u>TYPE</u>	<u>REGION (if any)</u>
Illinois	Proposed	Regional- Reciprocal	<u>MIDWEST/MIDCENTRAL (6 States)</u> IN, IA, KY, MI, MO, WI
Indiana	Awaiting Governor's signature. Effective date January 1, 1986	Regional- Reciprocal	<u>MIDCENTRAL (4 States)</u> IL, KY, MI, OH
Iowa	None		
Kansas	None		
Kentucky	Effective	Regional- Reciprocal (National trigger after 2 years (1987))	<u>MIDCENTRAL (7 States):</u> MO, IL, IN, OH, TN, VA, WV
Louisiana	None		
Maine	Effective	Open Entry	All States
Maryland	Awaiting Governor's signature. Effective date July 1, 1985	Regional- Reciprocal	<u>SOUTHEAST/MIDCENTRAL</u> (contiguous only until 1987; 14 states & DC thereafter) AL, AR, DE, FL, GA, KY, LA, MS, NC, PA, SC, TN, VA, WV, DC
Massachusetts	Effective	Regional- Reciprocal	<u>NEW ENGLAND (5 States)</u> CT, ME, NH, RI, VT
Michigan	Proposed	Regional- Reciprocal (National trigger after 2 years)	<u>MIDWEST^d (5 States)</u> IL, IN, MN, OH, WI
Minnesota	Proposed	Regional- Reciprocal	<u>MIDWEST (4 States)</u> IA, ND, SD, WI
Mississippi	None		
Missouri	Proposed	Regional- Reciprocal	<u>MIDWEST-SOUTH</u> (8 States) AR, IL, IA, KS, KY, NE, OK, TN

<u>STATE</u>	<u>STATUS OF LEGISLATION</u>	<u>TYPE</u>	<u>REGION (if any)</u>
Montana	None		
Nebraska	None		
Nevada	Proposed	Regional- Reciprocal (National trigger 1/1/89)	<u>WEST (11 States)</u> AK, AZ, CO, HI, ID, MT, NM OR, UT, WA, WY
New Hampshire	Defeated	National- Reciprocal	
New Jersey	None		
New Mexico	Defeated	Regional- Reciprocal	<u>SOUTHWEST (5 States)</u> AZ, CO, OK, TX, UT
New York	Effective	National- Reciprocal	All States
North Carolina	Effective July 1, 1985	Regional- Reciprocal	<u>SOUTHEAST (12 States & DC)</u> AL, AR, FL, GA, KY, LA, MD, MS, SC, TN, VA, WV, DC
North Dakota	None		
Ohio	Proposed	Regional- Reciprocal (National trigger after 4 years)	<u>MIDCENTRAL/MIDWEST</u> <u>(13 States & DC</u> <u>contiguous States only</u> <u>for 2 years)</u> DE, IL, IN, KY, MD, MI, MO, NJ, PA, TN, VA, WV, WI, DC
Oklahoma	None		
Oregon	Effective July 1, 1986	Regional- Reciprocal	<u>WEST (8 States)</u> AK, AZ, CA, HI, ID, NV, UT, WA
Pennsylvania	None		
Rhode Island	Effective	Regional- Reciprocal (National trigger 6/30/86)	<u>NEW ENGLAND (5 States)</u> CT, ME, MA, NH, VT

<u>STATE</u>	<u>STATUS OF LEGISLATION</u>	<u>TYPE</u>	<u>REGION (if any)</u>
South Carolina	Effective July 1, 1986	Regional- Reciprocal	<u>SOUTHEAST (12 States & DC)</u> AL, AR, FL, GA, KY, LA, MD, MS, NC, TN, VA, WV, DC
South Dakota	Effective	National ^{1/}	All States
Tennessee	Effective July 1, 1985	Regional- Reciprocal	<u>SOUTHEAST (13 States)</u> AL, AR, FL, GA, IN, KY, LA, MS, MD, NC, SC, VA, WV
Texas	Proposed	Regional- Reciprocal	<u>SOUTHWEST (10 States)</u> AZ, AR, CO, KS, LA, MS, MO, NM, OK, WY
Utah	Effective	Regional- Reciprocal	<u>WEST (11 States)</u> AK, WA, OR, ID, WY, MT, CO, NM, AZ, NV, HI
Vermont	None		
Virginia	Effective July 1, 1985	Regional- Reciprocal	<u>SOUTHEAST (12 States & DC)</u> AL, AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, WV, DC
Washington	Awaiting Governor's signature. Effective date July 1, 1987	National- Reciprocal	All States
West Virginia	None		
Wisconsin	Proposed	Regional- Reciprocal	<u>MIDWEST (7 States)</u> IL, IN, IA, MI, MN, MO, OH
Wyoming	None		

^{1/} A South Dakota bank that is acquired by an out-of-state bank holding company may not thereafter open additional branches by merger, consolidation or otherwise, and the out-of-state holding company may not acquire any additional existing banks in South Dakota.

SMALL BANKS IN THE CALIFORNIA BRANCH BANKING ENVIRONMENT

Proposals to reduce barriers to bank geographic expansion, whether on a statewide basis or an interstate basis, raise questions relative to the future of smaller banking institutions. Specifically, can small banks compete with the statewide firms? Will there be incentives for the formation of new banks in markets characterized by a large percentage of total assets being held by a few statewide firms?

The data suggest that, while the large banks in a statewide banking state control a large percentage of state banking assets, this does not mean that smaller banks cannot compete in the state's major banking markets. The California experience, developed over several decades of statewide branch banking, illustrates the possibilities for small banks. Table 1 presents the size distribution of California banks at year-end 1984. As the table indicates, 332 of 435 banks have assets of less than \$100 million, and only six institutions have over \$5 billion of assets.

Table 1
Number and Asset Size Distribution of California Banks

Asset Size	Number of Banks	Percentage of Total State Banking Assets Held by Firms in Each Size Class
Less than \$10 million	17	0.05
\$10 million to \$25 million	100	0.78
\$25 million to \$50 million	121	1.93
\$50 million to \$100 million	94	3.00
\$100 million to \$250 million	58	3.90
\$250 million to \$500 million	21	3.35
\$500 million to \$1 billion	7	2.44
\$1 billion to \$5 billion	11	10.59
Over \$5 billion	6	73.96
	435	100.00

A - 2

In spite of the dominant asset position of the largest banks, there appears to have been adequate incentives for the formation of new banks in California. Table 2 presents the rate of bank formation in California over the years 1970 through 1983. In these years, 355 new banks were chartered in California. In 1983, California accounted for 16.9 percent of all new banks in the United States. Thus, the existence of statewide branch banking does not appear to have deterred investors in new banks.

Table 2
Bank Chartering in California, 1970 - 1983

Year	Number of New Banks	New Bank Charters in California as a Percentage of All New U.S. Bank Charters
1970	6	3.4
1971	7	3.6
1972	17	7.3
1973	24	7.2
1974	18	5.0
1975	17	6.9
1976	13	8.1
1977	14	9.1
1978	13	8.8
1979	24	11.8
1980	46	22.4
1981	42	21.1
1982	53	16.8
1983	61	16.9

These data suggest that, at least in California, the existence of large statewide banks has not led to the demise of small banks. In addition, the incentives for new bank formation have been maintained.

SMALL BANKS IN THE NEW YORK BRANCH BANKING ENVIRONMENT

The State of New York has had a shorter history of statewide banking than California, and the comparison may be of interest in evaluating the existence of small banks in a state containing many of the nation's largest banking organizations. New York adopted statewide banking in 1976, and therefore has had less than a decade of experience, as compared to the long history of statewide banking in California.

Table 1 presents the asset size distribution for banks in New York as of the end of 1984. As in California, the largest banks hold the overwhelming percentage of total statewide banking assets. Yet, as in California, there are a significant number of smaller institutions; 8% of the 149 banks, or 57 percent of all banks, have assets of less than \$100 million.

Table 1
Number and Asset Size Distribution of New York Banks

Asset Size	Number of Banks	Percentage of Total State Banking Assets Held by Firms in Each Size Class
Less than \$10 million	11	0.02
\$10 million to \$25 million	17	0.09
\$25 million to \$50 million	28	0.29
\$50 million to \$100 million	29	0.60
\$100 million to \$250 million	23	1.09
\$250 million to \$500 million	9	0.95
\$500 million to \$1 billion	7	1.28
\$1 billion to \$5 billion	12	6.29
Over \$5 billion	13	89.46
	149	100.00

Table 2 presents the record of new bank charters in New York for the period 1970 - 1983. Although the bank formation rate in New York was substantially lower than in California, the difference can probably be explained by the

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differences in growth rates between the two states. Like the California

Table 2
Bank Chartering in New York, 1970 - 1983

Year	Number of New Banks	New Bank Charters in New York as a Percentage of All New U.S. Bank Charters
1970	2	1.1
1971	4	2.1
1972	4	1.7
1973	3	0.9
1974	6	1.7
1975	4	1.6
1976	1	0.6
1977	5	3.3
1978	2	1.4
1979	1	0.5
1980	2	1.0
1981	2	1.0
1982	1	0.3
1983	3	0.8

experience, however, the New York data do suggest that small banks survive the expansion of branch banking and that new banks will be forced regardless of the degree of statewide dominance of the largest organizations.

EXHIBIT C

Litigation Involving Regional
Reciprocal Statutes

The Board has issued seven orders approving interstate acquisitions of banks by bank holding companies pursuant to regional interstate banking statutes. Six of the orders involve New England acquisitions pursuant to statutes enacted by Connecticut, Massachusetts and Rhode Island^{1/} and one

^{1/}

1. Bank of New England Corporation/CBT Corporation, 70 Fed. Res. Bull. 374 (March 26, 1984), approving the merger of the fourth largest Massachusetts bank holding company and the largest bank holding company in Connecticut.
2. Hartford National Corporation/Arltru Bancorp., 70 Fed. Res. Bull. 353 (March 26, 1984), approving the acquisition by the second largest Connecticut bank holding company of the eighth largest bank holding company in Massachusetts.
3. Bank of Boston Corporation/Colonial Bancorp., 70 Fed. Res. Bull. 524 (May 18, 1984), approving the acquisition by the largest bank holding company in New England of the fourth largest bank holding company in Connecticut.
4. Bank of Boston Corporation/RIHT Financial Corporation, 70 Fed. Res. Bull. 737 (Aug. 20, 1984), approving Bank of Boston's acquisition of the second largest bank holding company in Rhode Island.
5. Fleet Financial Group, Inc., 70 Fed. Res. Bull. 834 (October 4, 1984), approving the acquisition by the largest bank holding company in Rhode Island of de novo banks in Boston and Hartford.
6. Hartford National Corporation, 71 Fed. Res. Bull. 43 (November 19, 1984), approving the acquisition by the second largest bank holding company in Connecticut of a de novo bank in Providence.

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order involves the southeast region, the merger of Florida and Georgia bank holding companies.^{2/}

Each of the applications for Board approval to acquire a bank across state lines pursuant to regional interstate statutes was protested before the Board^{3/} on the basis that the regional interstate statutes violate the Commerce, Compact and Equal Protection Clauses of the United States Constitution. The Board addressed each of these issues and made detailed findings in a lengthy Appendix to its first two approval orders involving regional interstate statutes.^{4/}

With respect to the Commerce Clause issue, the Board determined that absent the authorization of Congress in the Douglas Amendment of the Bank Holding Company Act, 12 U.S.C. 1842(d), the regional interstate statutes impose a burden of the type found by the courts to violate the Commerce Clause. The Board then considered the authorization by Congress in the Douglas Amendment and found that the Douglas Amendment does not appear on its face to show an intent by Congress to authorize

^{2/} SunTrust Banks, Inc./SunBanks, Inc./Trust Company of Georgia, 71 Fed. Res. Bull. 176 (January 8, 1985), approving the merger of second largest Florida bank holding company and the third largest bank holding company in Georgia.

^{3/} Citicorp, New York, New York, protested each application, and it has sought judicial review of each of the Board's approval orders. Northeast Bancorp, Stamford, Connecticut, challenged the first two Board orders.

^{4/} See the first two cases listed in note 1.

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discriminatory restrictions of the type involved in regional interstate arrangements and that the provision's scant legislative history offered little guidance. Despite its doubts about the authorization of discriminatory state action in the Douglas Amendment, the Board decided it should hold state statutes authorizing interstate banking arrangements unconstitutional only upon clear and unequivocal evidence. Applying this test and based upon judicial guidance contained in Iowa Independent Bankers Association v. Board of Governors, 511 F.2d 1288 (D.C. Cir. 1975), the Board concluded that "while the issue is not free from doubt, there is no clear and unequivocal basis for a determination that [the Massachusetts and Connecticut statutes] are inconsistent with the Commerce Clause. . . ." Bank of New England Corporation, 70 Fed. Res. Bull. 374, 377 (1984); Hartford National Corporation, 70 Fed. Res. Bull. 353, 354 (1984).

The Board also found there was no basis to hold that the regional interstate statutes clearly and unequivocally violate the Compact Clause. The Board applied the standard enunciated by the Supreme Court in United States Steel Corp. v. Multistate Tax Commission, 434 U.S. 452, 470 (1978), that an agreement among the states does not establish a compact in violation of the Compact Clause unless it enhances state power at the expense of federal supremacy. The Board read the Douglas Amendment as conferring on the states authority to regulate entry of out-of-state bank holding companies without

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impinging on the federal interest in such regulation as that concept has been articulated in the Supreme Court's Compact Clause cases.

Finally, the Board concluded the regional interstate statutes do not clearly and unequivocally violate the Equal Protection Clause. Under the traditional case law of the Supreme Court applicable at the time of the Board's decision, which upheld state economic legislation if it was rationally related to a legitimate state purpose, the Board found regional interstate statutes to be rationally related to legitimate state purposes in establishing a banking system responsive to local and regional needs, including responsiveness to local credit needs, avoiding undue concentration of banking resources and providing an opportunity for an experiment with limited interstate banking.

Each of the Board's approval orders has been challenged in the United States Court of Appeals for the Second Circuit. The Court of Appeals has stayed consummation of the interstate acquisitions and mergers on two occasions -- to allow the Court of Appeals to hear the case and, even after the Court of Appeals rendered its decision upholding the Connecticut and Massachusetts statutes as constitutional, to permit Supreme Court review. As a consequence of these stays by the Court of Appeals none of the interstate transactions approved in the Board's seven orders, including the de novo acquisitions, has been consummated.

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The decision of the Court of Appeals,^{5/} filed August 1, 1984, upheld the constitutionality of the Connecticut and Massachusetts regional interstate statutes and affirmed the Board's approval orders. The Court found that the Douglas Amendment constituted a renunciation of federal interest in regulating the interstate acquisition of banks by bank holding companies. In deciding that the states have the authority to lift selectively the ban on interstate acquisitions of banks imposed by Congress in the Douglas Amendment and thereby to create interstate banking regions, the Court noted that nothing in the language or legislative history of the Douglas Amendment supports the contention that an individual state must permit acquisitions by all out-of-state bank holding companies if the state permits acquisitions by any.

The Supreme Court was requested to review the decision of the Court of Appeals, and in January 1985 the Supreme Court agreed to hear the case.^{6/} The State of New York, New York State Bankers Association and both United States Senators and certain members of the House of Representatives from New York filed briefs with the Court opposing regional interstate statutes as unconstitutional. The State of Massachusetts

^{5/} Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System, 740 F. 2d. 203 (2d Cir. 1984).

^{6/} Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System, No. 84-363 (argued April 15, 1985).

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joined with the bank holding companies of Massachusetts and Connecticut that were parties to the challenged acquisitions in filing briefs in support of the regional statutes. The case was argued before the Supreme Court on April 15, 1985.

The issues originally placed before the Court involved the Commerce Clause and Compact Clause of the Constitution, and centered, as they had before the Board and the Court of Appeals, on an interpretation of the Douglas Amendment and whether that Amendment provided an "unmistakably clear"^{7/} authorization by Congress to permit the states to discriminate and burden commerce through regional interstate statutes.

The Supreme Court decision, with four justices dissenting, on March 26, 1985, in the case of Metropolitan Life Ins. Co. v. Ward, No. 83-1274, prompted the petitioning parties to raise an argument under the Equal Protection Clause not originally raised before the Supreme Court although, as noted above, it was raised before the Board. The Metropolitan decision held that state legislation that taxes out-of-state insurance companies at a higher rate than in-state companies in order to promote in-state business at the expense of out-of-state competitors was unconstitutionally

^{7/} South-Central Timber Development v. Wunnicke 104 S.Ct. 2237, 2242 (1984) -- requiring that federal legislation authorizing a departure from normally applicable Commerce Clause standards must be "unmistakably clear" -- was decided after the Board issued its first interstate order but employing the standard used by the Board.

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discriminatory. The Court held that this statute did not advance interests rationally related to legitimate state purposes under the Equal Protection Clause. This case thus raises a question as to whether regional interstate statutes which apply different rules to different groups of out-of-state banks, depending on geographic location, violate the Equal Protection Clause.

A decision by the Supreme Court that the regional statutes are unconstitutional on Commerce Clause or Compact Clause grounds could be remedied by an amendment to the Bank Holding Company Act showing the intent of Congress to permit regional interstate compacts, since the Congress has the authority to sanction by federal statute state laws burdening commerce or creating a compact. Congress does not appear to have the authority to sanction violations of the Equal Protection Clause should the Court decide that regional statutes are unconstitutional on that basis.

The past practice of the Court indicates that a decision is likely to be issued in June or July, 1985.

ATTACHMENT IV

STATEMENT ON DEFINITION OF BANK

Public policy has long recognized that commercial banks perform a unique and critical role in the economy and the financial system. They are operators of the payments system; they are custodians of the bulk of liquid savings; they are the principal suppliers of short-term credit; and they are the critical link between monetary policy and the economy. Moreover, the fortunes of individual institutions are so intertwined that instability of one may infect another. In recognition of these circumstances, a federal safety net -- specifically the Federal Reserve discount window and federal deposit insurance -- has long been provided to help protect the system. Individual banks are subject to a system of regulation and supervision to help assure their safety and soundness.

Integral to that approach, the Bank Holding Company Act allows ownership of a bank by another company only if that company engages in activities that "are closely related to banking and a proper incident thereto." That provision is designed to enforce a basic separation of banking and commerce, and thus limit conflicts of interest and avoid undue concentration of resources. The law also provides for some supervision and inspection of the holding company as a whole, recognizing that, in practice, the fortunes of one enterprise within a holding company cannot be wholly separated from those of its affiliates. The provisions of the Bank Holding Company Act also provide restrictions on interstate banking by a holding company, paralleling the restrictions on interstate branching in the McFadden Act.

The basic concerns about the separation of commerce and banking remain valid, and should be a point of departure today in considering the "nonbank bank" issue. The definition of a bank is critical to a policy that sets out to separate banking and commerce and to enforce restrictions on interstate banking. The Bank Holding Company Act defines a bank as an institution that both accepts demand deposits and makes commercial loans. That definition was designed to exclude savings and industrial banks (which at the time had little or no demand deposits or other transactions accounts or commercial lending authority) and limited-purpose trust companies.

While thrift institutions today increasingly do commercial lending and can accept transaction accounts of individuals, FSLIC-insured institutions remain exempt under the terms of the Garn-St Germain Act passed in 1982. Moreover, as

other forms of transactions accounts have developed with the basic characteristic of demand deposits, institutions with a bank charter can also take all kinds of deposits from the public (including under court rulings NOW accounts) other than demand deposits and make commercial loans without coming under the restrictions of the Bank Holding Company Act. These are the so-called "nonbank banks," for which there have been hundreds of applications.

Specifically, one form of "nonbank bank" may be owned by any company -- a steel company, a retailer, a securities firm, an insurance company, or a real estate developer. The parent company is not subject to any of the limitations of the Bank Holding Company Act designed to limit risk or conflicts of interest and to avoid unfair competition or excessive concentration of economic power. Thus, in its present guise, the "nonbank bank" undermines the basic separation of banking and commerce -- a concept with deep roots in both English and American traditions.

That seems to be the fundamental issue at stake in closing the "nonbank bank" loophole. By permitting commercial companies to provide through subsidiaries almost all the same functions as full service banks, and to obtain access to the payments system, the discount window, and deposit insurance, both the principle and the practical reality of the present restrictions of the Bank Holding Company Act will be seriously undermined over time. The competitive position of those banks still subject to the Act will inevitably be damaged, potentially weakening the system as a whole.

The "nonbank bank" is also, and today more commonly, a device by which a bank holding company, or a commercial firm, can escape from the restrictions on interstate banking encompassed in the Douglas Amendment to the Bank Holding Company Act. In fact, interstate banking is a reality in many areas through Edge Act subsidiaries, loan production offices, finance company and mortgage banking affiliates, credit card operations, ATM networks, and otherwise. The nonbank bank offers the added avenue of on-site offices for a full range of consumer business or commercial lending combined with deposit taking. Although some liberalization of current restrictions is justified, that question should be approached on its own merits rather than by permitting interstate banking through an unintended "back door" device, with the inefficiencies and inequities that involves.

There is a broad consensus that it is important to preserve the basic policies of the Bank Holding Company Act and that, accordingly, it is essential to close the "nonbank bank"

loophole as part of any legislative approach toward banking. Basically satisfactory legislative provisions to achieve that were contained in separate bills last year. One was reported by the House banking committee and another adopted by the full Senate. While detailed differences in approach were not fully resolved, it appeared that it was other provisions of proposed banking legislation, rather than basic disagreements on the "nonbank bank" question that stymied enactment.

H.R. 20 basically follows the approach of this consensus. It broadly applies the provisions of the Bank Holding Company Act to all FDIC-insured commercial banks whatever their particular mix of business. In addition, those uninsured institutions that offer transaction accounts and make commercial loans would continue to be covered. This approach is broadly satisfactory so far as it goes, as would be the similar provisions of H.R. 15.

These bills would bring so-called consumer banks clearly within the scope of the provisions of the Bank Holding Company Act. The suggestion has been made by others that banks primarily aimed at serving the consumer might be exempted from the general principle of the separation of banking and commerce and from any restrictions applicable to ordinary banks on interstate banking.

However beguilingly presented as a "family bank" proposal, such an initiative is misguided. The great bulk of the number of existing banks and other depository institutions are already "family" or "small business" oriented. There are almost 20,000 banks and thrifts in this country, nearly all actively competing for consumer business. Many of them do little commercial lending; for instance, almost 20 percent of commercial banks have 5 percent or less of their assets in loans to businesses, and nearly half have less than 20 percent of assets in such loans.

There is no justification for permitting commercial, industrial or securities firms to compete with these institutions for insured deposits and other banking services under different ground rules as to ownership. The effect could only be to undermine the public policy objectives incorporated in the Bank Holding Company Act generally, and there would be the appearance and reality of unfair competition with banks subject to the Act.

Do we really want, for example, a retail business to be able to gather deposits under the protection of federal insurance and to use those deposits to fund a credit card they sponsor more cheaply than retailing competitors? Do we want to

bless interstate consumer banking simply because there is a nonbank owner? Do we want to encourage joint marketing efforts and "tie-ins," implicit or explicit?

If we are not sensitive to these concerns, then what is the justification for the present restrictions in the Bank Holding Company Act?

Some of the "family bank" concepts propose a kind of sugar coating in the form of higher capitalization, "life-line" banking requirements, and rules requiring prompt deposit availability. If these are indeed valid objectives of legislation -- and no justment is made on that point now -- the legislation should apply to all depository institutions and not to just a special few.

In other respects, the coverage of H.R. 20 must be broadened. As drafted, H.R. 20 has no provision with respect to the treatment of thrift institutions -- savings banks and savings and loans.

For some federally insured thrifts -- namely, those owned by multiple savings and loan holding companies -- no legislative action appears required since their holding companies would remain subject to the Savings and Loan Holding Company Act, which has restrictions similar to those of the Bank Holding Company Act. However, others -- including FDIC-insured savings banks and privately insured thrifts -- would be subject to neither Act, and unitary S&L's may engage in substantial nonresidential lending activities without any limitations on the commercial or industrial activities of their corporate owners. Left unattended, the effect would plainly be to deflect the energies now reflected in "nonbank banking" into banking in the guise of thrift institutions -- "nonthrift thrifts."

In recent years, powers available to thrifts have become much more like those available to banks, and indeed the range of thrift powers today, particularly those of state-chartered institution, often exceeds that of banks. Paralleling that development, there has also been increasingly clear recognition of the need to adopt rules to assure reasonably comparable regulatory treatment.

Considerations of competitive equity alone dictate that the privileges of, and restrictions on, banks and thrifts be brought into a more coherent relationship. But it is not just a matter of competitive equity. Restrictions on powers of bank holding companies and on "nonbank banks" will inevitably be undercut, and rapidly, to the extent thrift institutions

with banking powers can simply substitute as a vehicle for undertaking a wide range of banking services, violating the basic separation of banking and commerce.

Difficult questions are posed by firms that already have operations on both sides of the line between commerce and "thrift banking." A number of industrial or commercial firms own thrifts, and operate those thrifts as separate and distinct entities without significant problems arising. Those combinations might logically be permitted to continue on their present basis. However, in the environment we now face, these questions need to be approached with an eye toward the future, and a firm policy established with respect to which new combinations are acceptable and which are not.

To deal with this problem, only those thrifts that have a high percentage of their assets in home mortgages should be exempt from the same rules as to ownership applicable to banks and multiple S&L holding companies. Accordingly, present law should be strengthened to require that such a "qualified" thrift institution have at least 65 percent of its assets in residential mortgages or housing-related investments.

There is no sound rationale for including residential mortgage originations and sales in such a calculation. Commercial banks, mortgage banks, and others are all active mortgage originators. The distinguishing characteristic of an S&L and many savings banks historically -- and the characteristic that historically has justified special federal support -- was that they devoted relatively large portions of their own resources to support housing.

A substantial commitment to investment in housing should continue to be the test for exemption from certain policies embodied in the Bank Holding Company Act and the Savings and Loan Holding Company Act for multiple S&L holding companies. Furthermore, any holdings of liquidity included in a thrift test should be confined to amounts legally required.

A further step is necessary to limit conflicts of interest and tie-ins when a qualified thrift has a commercial owner. Specifically, joint marketing of services and products should be prohibited.

"Nonthrift thrifts" need not be brought under the Bank Holding Company Act administered by the Federal Reserve. Rather, institutions that have essentially the same characteristics as commercial banks should have broadly parallel restrictions on combinations with commercial firms, and those restrictions should be administered by the

appropriate regulator -- for savings and loans and federal savings banks, the Federal Home Loan Bank Board. Moreover, about three-quarters of all savings and loans would meet this proposed thrift test and thus would not be restricted as to commercial ownership.

H.R. 20 does not prohibit an affiliation of thrift institutions and nonmember banks with securities firms. That existing loophole in the Glass-Steagall Act should be closed in the interest of competitive equity and the purposes of the Glass-Steagall Act. Such a provision has been recommended by the Federal Home Loan Bank Board with respect to thrifts. In all these areas, appropriate transition periods should be provided and other detailed questions need to be resolved.

Finally, the Chairmen of the Senate and House Banking Committees have strongly supported July 1, 1983, as the appropriate date for grandfathering nonbank banks. Even before that date, institutions were well aware that the nonbank bank loophole was a matter of policy and Congressional concern. H.R. 20 would grandfather about 24 FDIC-insured nonbank banks; most of these are small in asset size, with at least 10 essentially engaged in trust activities and six or seven in credit card operations. Given this situation, grandfathering as of the July 1, 1983, subject to appropriate conditions to assure that their grandfather status is not abused by expansion geographically or otherwise, would not be inconsistent with the objectives of the Act.

Should the grandfather date be moved toward the current date, an increasing number of insurance, securities, and retail firms that were fully on notice about the likelihood of federal legislation would be permitted to retain bank operations. Few of these institutions have yet made substantial investments, and the larger number of charter rights that would be involved would increasingly impair the objectives sought by H.R. 20.

A Federal District Court in Florida has enjoined the Comptroller from issuing final nonbank bank charters because it found, as a matter of law, that the National Banking Act does not permit the Comptroller to issue a charter which does not provide for the exercise of full National banking powers. As a result of that decision, final National bank charters for new nonbank banks are not currently possible, and the Federal Reserve Board has suspended processing such applications by bank holding companies. However, state-chartered nonmember "nonbank banks" can still be created. While final disposition of the legal issues involved for the National banks may take some time, any reversal of the District Court opinion will quickly touch off a flood of new National nonbank banks. Consequently, the need for clear and effective action to deal with the nonbank bank questions continues to rest with the Congress.

The CHAIRMAN. Thank you, Chairman Volcker.

Senator Proxmire and I were just discussing that that is without doubt the briefest statement you have ever presented to this committee and we appreciate it.

Your statement implies that you believe a simple loophole closing bill would be an inadequate response to the ongoing changes in the financial services industry; is that correct?

Mr. VOLCKER. Yes.

ADDITIONAL RESTRICTIONS

The CHAIRMAN. You also call for additional restrictions on the ability of States to expand the powers of their own State-chartered depository institutions. Some people might consider this a rather serious undermining of the dual banking system. Do you feel it is? How do you respond to that complaint?

Mr. VOLCKER. I don't feel that it is. We recommend this very strongly in the area of safety and soundness. The Congress has, on important and I think numerous occasions in the past, developed rules for the banking system that apply to States as well as to Federal legislation. That is true of the Glass-Steagall Act; it is true of the override of State usury laws, for instance. I think where there is an important national purpose to be served, some limitations ought to be put around the powers of States.

I think we can preserve room for State initiative and experimentation in many areas, and we should where that is possible; I think that's desirable. But when they undertake actions which I think are motivated by essentially parochial reasons, I think the Federal Government has every right to step in and set the general ground rules.

The Federal Government is the insuring agency and all these institutions are eligible for Federal Reserve borrowing, so I think there is both ample precedent and ample substantive reason to take that step.

The CHAIRMAN. You also, here today and in your testimony before the House, call for an expanded Federal role in support of interstate banking. We traditionally have left that to the States to make those decisions. That's why in S. 2851 we approved the concept of regional banking.

Do you feel it's necessary for the Federal Government to step in? My feeling is that interstate banking is occurring in the State legislatures of this country and, although I may feel differently at some times, I don't think the votes are anywhere close in Senate or the House to suddenly approve full interstate banking. I think it's going to be more of an evolutionary process through the State legislatures. How do you feel? Do you think we should intervene in this area or allow the States—

Mr. VOLCKER. We obviously are proposing that the Federal Government intervene.

The CHAIRMAN. Well, you are proposing that we intervene?

Mr. VOLCKER. Yes.

The CHAIRMAN. Yes.

Mr. VOLCKER. Yes, we are. The Federal Reserve is proposing that it intervene and I would certainly agree with you that this is going

on whether or not the States act because technology and communication permit it; Federal law permits it in the case of loan production offices, Edge Act, the activities of foreign banks. We now have a considerable movement toward regional or other arrangements by the States.

I think at this stage the Federal Government indeed has a responsibility to step in and say, again, that the States can have a considerable degree of initiative in this area but there is a certain basic framework that could reasonably be imposed, should be imposed, by the Federal Government to make sure that these arrangements also conform with the national interest.

The particular point of concern is that some of these regional arrangements can be rather cozy, discriminatory systems as they develop and I think could, left unattended, create more local concentration in banking than would otherwise be the case; that might not be healthy.

I think we can, again in this area, leave some room for State initiative. We're not imposing anything in our proposals on States that don't choose to engage in a broader system of interstate banking. But once they do, they would have to follow certain Federal guidelines.

REGIONAL ARRANGEMENTS LEAD TO INTERSTATE BANKING

The CHAIRMAN. Well, you do make that argument, that regional compacts should have that requirement. Isn't it highly likely that the regional arrangements would lead to nationwide banking rather than Balkanized banking; isn't that what you're really telling me without the requirement that you propose, that you're talking about? Now we have prohibitions against crossing State lines. You're saying that would be expanded somewhat to regional Balkanized areas and that's why you think once they open up, it should open up—

Mr. VOLCKER. We've seen two parallel developments starting largely from the idea of regional banking. One is regional banking per se. But a good many of the States which have enacted or are considering regional statutes are also saying that after some period of time it would at least be on a reciprocal basis with other States; but they allow some interstate banking, which is what we're proposing.

I do think from the national standpoint that that is the desirable end product once you go in the direction of interstate banking, and it would be enunciated as Federal policy.

The CHAIRMAN. Well, assume that the bill stayed the way it is and simply allowed regional banking without a clear cut phase-in to interstate banking. Would you phase either branching or multi-bank holding companies in metropolitan areas, as an example?

Mr. VOLCKER. We did say that, where this is an area either within metropolitan areas that extend across State lines or with neighboring areas of contiguous States.

It seemed to us that if you're going in a direction of legalizing regional arrangements, that these are the clearest areas where discrimination and arbitrariness would seem to arise so the Federal Government ought to move in that limited area in a way that I

think would be desirable from the standpoint of the banking system and the consumers served by banks in those borderline areas.

The CHAIRMAN. There is no better example, I suppose, than Washington, DC, and the Maryland and Virginia suburbs.

Mr. VOLCKER. Washington, DC is clearly a prime example, yes.

The CHAIRMAN. As you very well know, both the issue of non-bank banks and regional compacts are before the Supreme Court. My feeling is very strongly that I don't particularly care what the Supreme Court says about either one. I think we ought to make a legislative decision on both of those issues. Hopefully, not even waiting for the Supreme Court; would you agree?

Mr. VOLCKER. I would strongly agree with that, yes. I don't think this is the kind of problem—and it's so typical of so much going on in banking now—that gets left to the court or the agencies trying to apply some old law to existing circumstance, when what we really need is an expression of congressional policy. You're the one with the authority and the right and the responsibility to set the policy. We shouldn't be left trying to fit old law to present circumstances.

The CHAIRMAN. Well, I'm glad to hear you say that so strongly because I don't mean to denigrate the court by saying I don't care what they say about either issue.

The point is it is our responsibility to make a legislative decision and not have a copout by saying, well, we will abide by whatever the courts say. I doubt very much those nine Justices have listened to or read the thousands of pages of testimony on these issues, so it is our responsibility to make those decisions.

Mr. VOLCKER. I would, just to repeat, say the same thing about the position that we and the other regulators have been put in; I don't think it's our job to enunciate basic policy in these areas, but rather to carry out the policy set down by Congress. But it's not very clear at this point in many of these cases what the congressional policy is.

All we know is that in difficult circumstances we have to apply law to current circumstances that weren't envisioned at the time the law was passed.

The CHAIRMAN. Well, it extends to the courts; it extends to the regulators. If we don't set policy, you will. And it extends to the State legislatures. A lot of them are acting only because of our inaction when we say we don't like what they're doing.

Mr. VOLCKER. I think that is correct.

The CHAIRMAN. In my opinion as chairman of this committee, the reasons are incredibly impelling and compelling for us to move ahead and make some policy decisions rather than just close a couple of loopholes and then rely on the courts, the State legislatures, and the regulators to make decisions that we ought to be making.

Senator Dixon.

Senator DIXON. Mr. Chairman, I thank you for your usual very informative statement to the committee and I'd like to follow, in part, the line of questioning by my colleague, the chairman of this committee.

You recommend some additional changes this year in the basic bill that we passed last year, some of which I don't have too many problems with; they're modest changes some of which—particularly from those of us representing States, as an example, that do not now have interstate banking—recommend major changes. When you leave the question of compacts between the States which require the initiative of the States and go to the question of Federal intervention, you are opening up a brand new question that I think will divide a great many on the committee.

You see that; do you not, Mr. Chairman?

Mr. VOLCKER. I see that there could be disagreements about it. I don't think that conceptually, I am plowing new ground.

Senator DIXON. Well, may I say this. You are not covering conceptually new ground; you suggested this to us before. The point is, we didn't do it.

And the point I want to get to here is that we passed a bill ultimately last year out of this committee after, I don't know, many, many, many hours of hearings; we had separate meetings of the members of this committee on both sides of the aisle concerning the bill. We had innumerable roll calls on the separate powers questions and everything else. We finally, I think, brought together a sufficient majority here to obviously control the results on the floor of the Senate where we received a very fine vote for this bill.

We sent it to the House too late, Mr. Chairman. And I want to suggest at this point, in the first place the House is not real wild about some of the ideas we have on the Senate side about this bill and particularly the powers questions.

SIMILAR BILL TO S. 2851

And so I guess I just want to ask you whether you don't think it would be wise for the committee to not cover too much new ground and simply vote out a bill very similar to the one that we recommended last year in the hopes that the Senate will follow suit again and send to the House early-on, possibly no later than early June, a bill that the House can work its will on.

Mr. VOLCKER. You raise some questions of legislative tactics that are, I think, outside my area. These questions arise in the House—

Senator DIXON. Oh, now, Mr. Chairman, you're much too modest. You know a little about legislative operations.

Mr. VOLCKER. I'll make a few comments, but I do think that you raise some tactical as well as substantive questions.

The CHAIRMAN. Mr. Chairman, if I could interrupt you for 1 minute with all due respect to you. I do have some opinions on legislative tactics. I respect your testimony and your opinions but there isn't any way we're going to put that provision in this bill. [Laughter.]

Senator DIXON. Well, now that we resolved that in a bipartisan way—

Mr. VOLCKER. The changes that we're proposing in this bill, with the possible exception—depending upon how you view it—of the interstate provision, I don't think change the basic philosophy and thrust of the bill. They are clearly designed to strengthen two or

three of the provisions of the bill where we don't think you fully achieve the purpose which is consistent with the bill, because the provisions basically aren't drawn tightly enough.

Senator DIXON. And may I say, Mr. Chairman, I don't have any problem with a couple of those minor changes.

The only point I'm trying to make is——

Mr. VOLCKER. I don't think they're so minor, but I think basically they reinforce what the bill was meant to accomplish, as I see it.

Senator DIXON. Yeah.

Mr. VOLCKER. On the interstate banking question, that was one area where there was less testimony last year. We had no position at that time, but I think what's really happened is that the banking community as a whole has obviously debated this issue, and there's been an evolution of thinking which, in my opinion, has now reached the stage for the kind of legislation that we are proposing; that was not politically the case last year.

Now, the chairman apparently disagrees with that, but I think there are—and I would like to submit—very powerful reasons.

The CHAIRMAN. Mr. Chairman, at this point I can count four votes for even talking about full interstate banking, two from California and two from New York. Beyond that, I don't——

Mr. VOLCKER. Our proposal is not quite full interstate banking.

The CHAIRMAN. Even the figure, I can see as a nice little time bomb in the middle of my bill just blowing it all apart. [Laughter.]

Mr. VOLCKER. You know, I have to sympathize with your concerns, and I have to note, too, that it's been very controversial in the banking community. But there is a good deal of support by major banking organizations for precisely this kind of legislation, details——

The CHAIRMAN. You're right; I'm only looking at Senators and how they may vote.

Mr. VOLCKER. Give their thinking a little chance to evolve in the next few weeks.

The CHAIRMAN. Maybe they can get them up to 7 or 8 weeks. [Laughter.]

Mr. VOLCKER. We'll see.

Senator DIXON. Let me pursue the objective I had in mind, Mr. Chairman.

First of all, let me say, I don't want to pursue any further the interstate banking question. You've so testified before, that's fine. We all have separate opinions about that. Mine is, leave it to the respective States. But the point I want to pursue with you is the fact that after a long period of time and a great many hearings and a considerable amount of effort in this committee, we finally crafted a bill that a majority here could support with various degrees of enthusiasm, which passed the Senate with a majority, I think an extraordinary majority.

I suggested to the Chair right after the results, that I thought a minor miracle had ensued in that place.

Now I think our job is to try to get that bill out of here and to the Senate and to the House as quickly as possible.

I would ask you whether on the whole you do not think that the work product of the last session with reference to this bill was an adequate and satisfactory one from your perception of it.

Mr. VOLCKER. I certainly think it was a large step forward. Now you tell me that you will get it out of the Senate as soon as possible and let's presume we get it into conference with the House and if anything needs to be improved maybe it should be done at that stage. That is nice, but I have to answer the same question in the House, if the question arises: Should they go ahead with a limited bill? And I say I don't know what the best legislative tactics are, but in the end, you've got to legislate across a considerable breadth of substance, and I hope that the end product that comes out of both the House and the Senate and finally gets enacted deals with some of these questions that I raise.

HOUSE WANTS LIMITED BILL

Senator DIXON. So do I, Mr. Chairman, and I would again pursue that question by saying to you that if we don't get a bill out of here and over there in apt time, what we ultimately will get, I think, is a very limited bill, which the House, in my view, really wants. So I would say once again that I would hope that you can cooperate with the committee in finding some changes that can be within the confines of what the accommodations of this committee will tolerate and that we can get a bill out of here shortly.

Mr. VOLCKER. I agree with your purpose entirely, and I would hope the committee could tolerate the limited changes that we're proposing, whatever you do on the interstate question.

Senator DIXON. I thank you, Mr. Chairman.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman. I would just like to commend Chairman Volcker for coming up and asking for some quick legislative action. I recall last year when you were up here talking about and asking for a moratorium. I think that your national trigger idea is going to end up in the same legislative graveyard.

Last year's S. 2851 sunsetted the regional banking authorization after 5 years. What about allowing the States and the marketplace to try to work their will, and then examine the situation at the end of that sunset period?

Mr. VOLCKER. You can do that, but I would prefer that you laid the framework out now. Why leave that uncertainty? I don't know what happens after the sunset period. You don't really contemplate that the States will go back and undo everything that's done during that period.

If regional is a good idea now, why does it stop after 5 years? Why can banks do it for 5 years and not do it thereafter?

I just think you are at a stage, and opinion in the banking community is at a stage, where you can simply go beyond what you did last year.

Senator MATTINGLY. Well, are you comfortable with the existing antitrust provisions in existing banking laws to adequately prevent undue concentration of resources in the banking industry?

Mr. VOLCKER. Not for—

Senator MATTINGLY. In other words, couldn't we end up with just four or five major banks in the United States?

Mr. VOLCKER. No. I think there is no chance of that. But in that connection we proposed some provisions to assure that you don't get combinations of the largest banks in the country. Under no circumstances would we end up with four or five anyway. We're still going to have many thousands of banking institutions in this country in any circumstances that I can foresee.

Senator MATTINGLY. Well, I don't know. I think the comments that you make a lot of times are interpreted as the legislative gospel. I think maybe we ought to leave the legislative tactics maybe to the committee.

Mr. VOLCKER. I agree with that.

Senator MATTINGLY. And I would just observe once again that I think you can comment and recommend all you want to about a national trigger, but the national trigger ain't going to succeed in this place.

That's all I have, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Mr. Chairman, let me defer for just a moment to one of my colleagues and pick up on the next round.

Senator GARN. Senator Dodd—or Senator Riegle was here.

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Chairman, I want to just ask you one question on the macroeconomic level. I don't want to get stuck on this point, because I want to get into the subject that we are here about, but we are trying to come up with a budget package, as you know, and we haven't managed to do it as yet, and it is approaching the middle of May, so the time is getting away from us.

You are on record as having said that you would like to see a deficit reduction figure in the coming fiscal year's budget of about \$50 billion. Is that close to right, in terms of what you'd like to see?

Mr. VOLCKER. Upwards of \$50 billion.

Senator RIEGLE. Upwards of \$50 billion.

If we could get \$35 billion, just on the basis of spending cuts, in the way of deficit reduction or we could get \$50 billion, if we had the spending cuts plus some revenue measures, would you rather have the \$35 or the \$50 billion?

Mr. VOLCKER. What I said is that I'd like to see you get as much as possible on the spending side. Get all of it there, if you can. If you can't do that, then I think you've got to turn to revenues.

PROBLEM BANKS NUMBERS INCREASED 40 PERCENT

Senator RIEGLE. The number of banks that have financial problems and need special scrutiny has increased almost 40 percent since the end of 1983, and the number is expected to climb even higher this year.

I think at the present time, there are about 793 problem institutions on the Comptroller's list as of the end of January of this year and 901 on the FDIC list, as of the end of February. And as I understand it, that includes at least three money-centered banks. So these are not just small banks. I can give you the citation out of the New York Times, if you are in doubt about that, or at least that is the information that has been made public.

But my question to you is, as you look at the situation, how serious is this problem? Is it your feeling that we are going to see more financial institutions on the problem list this year? I would like your assessment as to the magnitude of the problem today and where you think it is heading?

Mr. VOLCKER. I would hope that we are in the process of passing the crest of that problem, if that is the way to express it. I think there has been a lot of strain and pressure in areas of the financial system, partly as a reflection of the process of disinflation, I think. A lot of loans were made on different kinds of assumptions and in a different kind of economic environment, and it has taken and will take some time to deal with those problems, but those problems have been apparent, and I think attitudes are changing in the banking world. I hope that lending practices are changing. And, in reasonably equitable external economic circumstances, I think we can work our way through those problems.

Senator RIEGLE. Now when you say—your exact phrase I don't recall precisely, but it was to the effect that maybe we were past the crest of this thing, are you saying then that you don't think the number of problem banks is going to rise further?

Mr. VOLCKER. I am not making any particular forecast. That is not my favorite statistic, and I don't particularly have that total in mind.

Senator RIEGLE. Well, the reason I asked the question is because I think it is relevant to the degree to which we need to change the banking system and change it in terms of broadening out the activities that banks get into. I mean, if I thought we were at the point where we weren't going to see an appreciable further increase in banks on the problem list, I would have one level of concern, and if I thought that that list was likely to increase by 25 or 20 percent over the period of the next year or so, I would have quite a different level of concern. And I gather—can I draw from what you are saying, you don't expect to see an increase of 10, 15, 20 percent in the number of banks on the problem list in the future here?

Mr. VOLCKER. I don't follow the list. I don't particularly expect it, but I haven't analyzed it in those terms. But if I may say, with all respect, Senator, I don't think that question is relevant to this question of banking reform. I am not eager to have powers for financial institutions that I think are going to lead them into a quantum change in the kinds of risks they take. Some new powers may be helpful, in terms of minimizing risks and providing an outlet for energies and activities, or a complement to existing services that will support the safety and soundness of the system.

If a new power is going to undermine the safety and soundness of the system, I think it raises a question about that particular power and how it should be dealt with.

Senator RIEGLE. Well, you touched on that in another respect in your testimony on page 10, when you were talking about the thrift institutions, where you were saying that you thought that the thrift test ought to require at least 65 percent of a thrift's assets to be devoted to home lending. That would seem to be a sort of a going back to more traditional definition of activity, rather than away from a traditional definition of activity.

Mr. VOLCKER. That in itself is not a safety and soundness proposal. That is saying that if you are in the traditional type of activity, the activity that has indeed justified Federal support for that industry through the years, then you continue to get some privileges. If you don't follow the activity that has traditionally justified the special Federal attention and support, then you ought to be bound by rules that are similar to those for commercial banks. The issue that is particularly important here is whether or not you can mix banking with commerce. What I was saying is an institution may have thrift on the door, but if it acts like a bank and talks like a bank, makes noises like a bank, it ought to be subject to some of the same basic restrictions that a bank is subject to, particularly this one about mixture of banking and commerce.

Senator RIEGLE. Well, I think it is fair to go ahead and discuss changes in the banking system and in the financial institution system that we think makes sense, in terms of long-term trends and sorting things out in sensible ways, and so forth, but I don't agree with you that you can separate that out totally from the question of the soundness of the structure of the financial system. I am gathering you are not very apprehensive about it. I am hearing more and more apprehension expressed about it and more is being written about it.

The basis for my first question comes from an article that was in the New York Times on March 6, where it says "U.S. regulators expect rise in problem banks." It goes on to point out here, not just the statistics that I mentioned a minute ago, but it names the three money-centered banks that are on the problem list. I am not sure it is sufficient to simply say that those are not meaningful statistics or that we don't focus—I would like to know where those trend lines are going.

Mr. VOLCKER. There are problems in the banking system. There are strains—I am not denying that at all—relative to a very equitable history in the postwar period. I am not saying that these questions of safety and soundness are not relevant to your legislative package. I think they are at the core of your legislative package in many respects, and what a legislative package should be.

What I am saying is, I don't see any on-off switch here, no powers, or all powers related to—

Senator RIEGLE. I am not suggesting that either. So I don't want to be misinterpreted in that way, because that is not my intention to say that either. I am trying to decide off the basis of your professional judgment as to where the soundness and the stability of the structure stands today and how much tension and difficulty there is in that system.

I want to try to factor that into the judgment as to how much change we ought to now bring in on top of that set of problems.

So that is a judgment call, and we will debate that around here, and I am not sure any of us have set answers at the moment. I would like to start by understanding as clearly as I can the nature of the difficulties that we are now experiencing in the banking system and where those trend lines seem to be taking us.

Now let me try to even make it more specific, because, as I understand it, in 1983, the entire banking system in the country had loan losses that totaled \$8.3 billion, but I am told that one of the

leading New York bank securities firms is now estimating farm loan writeoffs. This gets into the agricultural credit problem. The farm loan writeoffs this year could total as much as \$12 billion. In other words, a figure in 1 year just from that sector that would be higher than the total of \$8 billion for the entire banking system for 1983. We've heard other estimates as well.

APPRAISAL OF THE AGRICULTURAL LOANS

If you can, I would like your appraisal of the agricultural loan problems as you see them coming back in through the banking system from large banks to small banks.

Mr. VOLCKER. There is no doubt that that is one sector of the economy where financial pressures are still growing, and banks that are directly and importantly involved in agriculture are going to be one group that is coming under increasing pressure rather than decreasing pressure.

If you just take the universe of banks, there is no doubt that there are going to be added pressures. Most of those banks, fortunately, start off in a very strong position. They have higher than typical capital ratios. They have had good earnings in the past, but in terms of change, they are undoubtedly coming under more pressure.

I haven't got the figures in front of me, but when you mention \$12 billion of losses, my memory is that all the commercial banks in the country only have about \$50 billion of agricultural loans, so I don't see how that kind of figure could apply to losses in commercial bank farm loans. Maybe it applies to some other universe.

Senator RIEGLE. Let me give you the citation. It is from a firm called Keefe, Bruyette & Woods, a New York bank securities firm. They indicate that they seek as much as \$12 billion of farm loan writeoffs by banks alone this coming year. Now that would be a very high percentage, if your estimate of \$50 billion of a total is high.

But I'll tell you, we've got a major farm problem growing in the country, and if you don't believe me, talk to some of the Republican State senators from farm States around here, and they can give it to you in very vivid terms, as can the Democrats.

Mr. VOLCKER. I think I am well aware of the problems in that sector of the economy, but it is a good illustration of the fact that there is nothing in this proposed legislation, in my opinion, that is going to aggravate those problems. Indeed, most of the banks involved in that particular sector of the economy are not the kinds of banks that are vitally interested in underwriting corporate securities or mortgage-backed bonds, or whatever. They are small community banks.

Senator RIEGLE. Well, if I may just finish by saying, I think you partly have a confidence issue here. Nobody knows what the legislation is going to look like. I mean, you can't assume that just because you start with one package that is what you end up. I have never seen that happen around here yet. So I think we still have to start by sizing the dimension of the problem of current stress and difficulty in the financial system. I don't think we really have done that today. How you then make subjective judgments as to what

further changes in structure are needed, you know, that is a debatable proposition, and we will work our way to some answers. But the clear sense I have is that the stress is still building up on the financial structure and on the banking system. I think we have to—if that is not so, or if in your judgment it's not so, then I would like to nail that down here today, and then we can go on to the question of the various choices that face us.

Mr. VOLCKER. I think there are strains. I am repeating myself, but I feel so strongly about it, I'll repeat myself once more. I look at this legislation importantly from the standpoint of what is going to strengthen the safety and soundness of the banking system, not undermine it. The kind of proposals that we support are totally consistent with that objective. I feel strongly about it, partly because there are stresses and strains in the banking system, and it is our job to be concerned with the safety and soundness of the system. I think the thrust of this legislation reflects that concern, not the reverse.

The CHAIRMAN. Senator Riegle, I hate to interrupt you, but I want to give every member here an opportunity. Chairman Volcker has a board meeting to go to, and I want to make sure that everybody here gets at least one opportunity for questions.

Senator RIEGLE. I agree with you, Mr. Chairman.

The CHAIRMAN. Senator Proxmire.

NATION IS ON VERGE OF GROWTH RECESSION

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Late last month, Mr. Volcker, Vice Chairman Martin warned that this Nation is on the verge of a growth recession, and that faster money growth may be needed.

Was Vice Chairman Martin reflecting the views of Vice Chairman Martin, or was he reflecting the views of the Federal Reserve System?

Mr. VOLCKER. I think he was speaking for himself, as members do upon occasion.

Senator PROXMIRE. He was speaking for himself?

Mr. VOLCKER. I don't want to say they necessarily differ or are about the same.

Senator PROXMIRE. Well, now let me ask you, Chairman Volcker. You do speak for the Federal Reserve, I take it.

What are the views of the Federal Reserve on the growth recession and the need for faster money growth?

Mr. VOLCKER. "Growth recession" is not a term I particularly like. I think we've got enough ways of characterizing the economy, and as: growth, relatively fast growth, slow growth, no growth, minus growth. I don't think we need other terms, and I don't use that one.

But I have expressed the opinion that I think there are imbalances that have developed in the economy increasingly, fundamentally related to the imbalance in the Federal budget. We have a situation where some areas of the economy are growing at a quite reasonable rate, but the goods-producing sector of the economy is under some pressure and has been essentially level for months.

Senator PROXMIRE. What's the bottom line? Does it mean we need faster money growth or not?

Mr. VOLCKER. We're going to have to debate that. You see that money growth has been relatively fast against our targets; looked at over the year as a whole, it's been more quiescent, a slow rate of growth, in the last month or two.

But look at the pattern over several months. It's been relatively high looking at M1, less so as you look at M2 and M3. Our policy is what it is as reflected in pressures on reserve positions in the market.

Senator PROXMIRE. Well, then I think you are telling me that your policy is remaining about the same, you're staying in neutral. Is that right?

Mr. VOLCKER. I think it's a fair characterization at the moment, but we always have another meeting coming up.

Senator PROXMIRE. You say the small banks can still survive under interstate banking and you present statistics from New York State to support your argument.

Now let's examine those statistics closely, they're quite revealing. They show that the 13 banks with more than \$5 billion in assets control about 90 percent of the banking business in New York State. On a nationwide basis, there are 66 banks with assets of \$5 billion or more. These banks control only 45 percent of the banking business. The 14,000-odd banks under the \$5 billion level control 55 percent of the business.

If the Nation were to emulate the New York experience, we would have 66 banks controlling 90 percent of the banking industry. The other 14,000 banks or what was left of them would have their share of the market reduced from 55 to 10 percent.

Would you be disturbed by that development?

Mr. VOLCKER. Yes; but I don't for a minute believe that it will take place. You get quite a misleading conclusion when you look at that frequency distribution in New York banks. I have asked the staff to try to develop some other indicators to give a fairer reflection of the distribution of New York State banking business, what might be thought of as local banking business.

If I'm looking at the same table you are, those 13 banks over \$5 billion in New York account for 90 percent of the business, because that includes some of the biggest banks in the world that have deposits or assets recorded in New York, because the office is in New York. But those assets or deposits grow from business outside the State of New York, so that's totally distorted as a reflection of the distribution of local business. You would not see that kind of concentration on a national level.

Senator PROXMIRE. Smaller banks all together only control about less than 1 percent of the New York State market.

Mr. VOLCKER. That's right. It would be more than 1 percent of the local business, but—just what percentage it would be, I don't know. We can't make that calculation from the statistics available federally.

REDUCTION IN NUMBER OF BANKS

Senator PROXMIRE. Let me try to get at it in another way then. Several months ago, the head of a large money center bank met with me in my office. He said that if we had unrestricted nationwide banking, we would go from about 14,000 banks to 300 banks, which, in his mind, was good.

Do you agree with that?

Mr. VOLCKER. No; I think you can look at the California experience, where we also gave you a table. California, of course, is a big growing State that has had statewide branch banking for I don't know how long—decades and decades. There are more than 400 banks just in the State of California alone. I don't see any reason why that kind of pattern would change appreciably.

Senator PROXMIRE. Well, California seems to me to buttress my case because in that case, you've got six banks with assets of over \$5 billion. They control 75 percent of the operation.

Mr. VOLCKER. With California and New York you're dealing with some of the biggest banks in the world and some of that—less so than in New York, but to some extent—is reflecting nationwide and international business that happens to be parked in California.

What you have, I think, is quite a healthy banking environment in California, one that's been characterized by the creation of a lot of new banks through the years, even in this context and with this overlooming presence of the Bank of America and some other very large statewide systems.

Senator PROXMIRE. Now I note on page 12 of your testimony, you believe, and I quote:

New arrangements for interstate banking should also include provisions to assure fair competition and avoid undue concentration of resources.

Problems that could come from undue concentration of resources have long been a concern of mine. Ten years ago, I introduced S. 2721, which would have amended bank merger laws, prohibit any further bank acquisitions by a banking organization already holding 20 percent of the banking deposits of any State.

So I was glad to see in attachment 3 of your testimony that you agree State mergers or acquisitions might be denied if the resultant institution would hold more than, for example, 15 or 20 percent of the State's banking asset.

You also note in attachment 3 that you believe banks might also be prohibited from obtaining through acquisitions more than some fixed share of the nationwide total of banking assets.

In June 1983, Dr. Phillip Caldwell of the Fed said, and I quote:

It does not seem unreasonable to me that banking organizations with 5 percent of the Nation's domestic deposits be prohibited from further acquisition.

Does that seem like a reasonable approach and percentage to you?

Mr. VOLCKER. Five percent of the Nation's deposits?

Senator PROXMIRE. Yes, sir.

Mr. VOLCKER. I might be inclined to make it less than that in major combinations. I'm not sure I would want to say, "You could not even buy a small institution or expand de novo above some

limit." But I would put a limit on the size of the acquisition they could make, yes.

Senator PROXMIRE. Would you put a limit on the aggregate size of the acquisitions?

Mr. VOLCKER. We could probably adjust that.

Senator PROXMIRE. Where you couldn't go above a certain percent?

Mr. VOLCKER. You could. I hate to get in a position where you can't even make a de novo step.

Senator PROXMIRE. But sometimes you're going to have to do that, are you not?

Mr. VOLCKER. In principle, I don't think we're in any disagreement. Just how you wrote the legislation, precisely where you put the limit, could be discussed. But, some limit, yes.

Senator PROXMIRE. Now, Vice Chairman Preston Martin has testified that junk bonds are not an appropriate investment for federally insured depository institutions.

Do you agree? And, if so, why?

RESTRICTIONS ON POORLY RATED SECURITIES

Mr. VOLCKER. I think, in general, too, that's a pretty loose term. There are restrictions now on national bank and member bank acquisitions of poorly rated securities. I don't think they're inappropriate.

Senator PROXMIRE. But they're not on thrifts.

Mr. VOLCKER. I must say, my concern is with financial institutions acquiring a lot of junk other than what's called junk bonds. That is part of my concern about this legislative package in general, in the area of real estate development in particular.

Senator PROXMIRE. But there's no limit on thrifts' acquisition of so-called junk bonds?

Mr. VOLCKER. I think that's correct.

Senator PROXMIRE. Do you think there should be?

Mr. VOLCKER. I think there should be appropriate limitations, yes. Yes; I would support that but I just want to say that that is not the only area of concern in connection with the purchase of extremely risky or speculative assets.

Senator PROXMIRE. As it passed the Senate last year, S. 2851 would have extended the Net Worth Certificate Program for 3 years.

Do you see any need to extend this form of financial assistance?

Mr. VOLCKER. I think that could well be the case in the thrift area. But I think that that kind of extension ought to be considered in connection with other measures to strengthen that industry, in the area of capital accounting practices, supervisory arrangements, so that the industry isn't simply supported indefinitely with net worth certificates without constructive measures being taken to bring it back to health.

Senator PROXMIRE. There have been suggestions that Congress give the thrifts a firm deadline for reaching capital adequacy as measured by generally accepted accounting principles.

Do you support this as a mandate? And, if so, what should be the percentage level and how many years would you give the thrifts to reach it?

Mr. VOLCKER. I haven't got precise answers to those questions. They certainly should be working in that direction. I think congressional direction and insistence upon that would be appropriate, but I don't have—

Senator PROXMIRE. The Bush Commission recommended 7 years. Does that seem reasonable to you?

Mr. VOLCKER. I think it would have to be a fairly long period of time, and that's not an unreasonable figure.

Let me say, the Home Loan Bank Board has been working—certainly in the direction of capital, and in other areas—to move in that direction. We have been very supportive of their efforts. The only question we have raised is whether they're moving fast enough. I think they could perhaps move—

Senator PROXMIRE. Thank you very much, Mr. Chairman. My time is up.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you.

Mr. Chairman, on page 13 of your statement, you express some anxiety about the formation of the so-called consumer or family bank. And you indicate that if these are not subject to the Bank Holding Company Act, that it would clearly undercut basic public policy.

SO-CALLED FAMILY OR CONSUMER BANKS

Will you capsule for us this morning your fears about the so-called consumer or family bank not being subject to the Bank Holding Company Act?

What is your objection to that?

Mr. VOLCKER. A very basic concern is that the policy that's been a long tradition in this country, that is, to separate commerce and banking because of conflict of interest and other questions such as concentration of resources, is a valid policy. If you're going to enforce that policy, it ought to be enforced across the board and you should not permit a gaping loophole in the policy.

I see a family bank, so-called, as a gaping loophole. Most banks in the United States think of themselves, I think, with justice, as family banks. If you, in effect, provide a license—which I think is what this amounts to—to commercial firms to bite off pieces of the banking business at their convenience, you end up not just violating that principle but weakening the fabric of banking generally; banking is subject to a certain body of law and regulation, including the separation of commerce and banking, and that ought to be enforced.

Senator SASSER. Along the same line, it was reported in this morning's Washington Post that, again, your colleague, Preston Martin—you seem to be answering a lot for Mr. Martin's comments today—made some comments on deregulation in a speech in Toyko. I was especially interested in Governor Martin's view on the U.S. transition to a deregulated financial environment. As re-

ported in the Post, he was quoted as saying: "It was not balanced, and the time to adjust was too brief."

Do you agree that the time to adjust to the deregulated environment has been too brief?

Mr. VOLCKER. I haven't read his remarks but I suspect what he may have been referring to is the thrift area where the point has been made that deposit interest rates were deregulated and they had to face the competition in that market. I think they had to face it anyway while they were still, as a practical matter if not by law, confined in considerable proportion to fixed rate mortgages on the asset side of the balance sheet.

There was an imbalance in that respect. But, I'm reading enough speeches by members of the Federal Reserve Board that I'm beginning to get confused. [Laughter.]

Senator SASSER. Well, Governor Martin also goes on to say and express the view, and I quote him: "No management can adequately achieve high performance in every field of activity the regulators may permit."

Well, now is there a risk, in your view, of overextending the activities allowed to the bank holding companies?

Mr. VOLCKER. There would be a risk if you did that. I don't think that danger exists in the laws now and not in our proposals, not in S. 2851. As a matter of theory, I could imagine that happening. But I don't think that's true of the legislation before you.

Senator SASSER. Well, how eager do you think corporations are in general to get into the banking business? What do you estimate is the level of interest?

Mr. VOLCKER. Some of them seem to be very interested. I don't know how wide that is, but some particular corporations seem to be very interested.

Senator SASSER. How many would buy or create consumer banks, in your judgment, if given the opportunity?

Mr. VOLCKER. I don't know, but if three or four very large ones did—and there seem to be some that are interested, that already have nationwide operations, large amounts of capital, they could make quite an impact in a short period of time. And it wouldn't be the numbers of separate organizations that were so important but the competitive impact and the market impact that relatively few institutions made.

But, I suspect, if the way were opened, you would see some nationwide change both of security firms and retailers, and you would see quite a lot of local activity in that area, too.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Mr. Chairman, let me welcome you back to the committee. Both chairmen back to the committee.

Chairman Volcker, I wonder if you might—you paint a pretty bleak picture here in terms of what's happening as a result of failure to enact legislation here in Congress. And on—I forget which page of your testimony opening, page 3, I guess, you said at the bottom of that page, you recite the various things that are happening. And then note that: something must be decided with or without congressional guidance.

I would tell you, as one member of this committee, given the experience of the last year or so, 2 years, despite the good efforts here and the fact we were unable to pass the bill, I'm not very optimistic about us enacting legislation.

Let's assume for just a second that I'm right. If you paint, as briefly as you can, a picture for this committee of what our financial institutions would look like in the coming year or so if we don't act, if we're leaving our future of these institutions up to court cases and so forth, where we've got a proliferation of decisions that are pending in the appeal process, what do you most fear as you look down the road?

And assume for a second that despite our efforts here, we're just not able to pass legislation in this regard?

CONCERN FOR BASIC SAFETY OF THE SYSTEM

Mr. VOLCKER. I think what I would most fear if I rank all my concerns, and I have lots of them in this area, is actions that are going to undermine the basic safety and soundness of the system. I think that arises through this kind of parochial competition among States as to what bank is going to have how many employees in its State; "If you come into my State and have so many employees, I'll permit you to do a lot of things that you'd like to do that your home State or the Federal Government won't permit you to do." Some of those things I think are dangerous.

Senator DODD. Your citing the Maryland situation recently.

Mr. VOLCKER. I don't know that Maryland has the widest powers but some States have essentially told banks they can do anything they want to, or thrifts can do anything they want to. And I think that's going a little far; the area that preoccupies us immediately is real estate development, where there is, I think, a clear record of experience in the thrift industry currently.

Right now, where there's a lot of speculative activity going on under the name of real estate development, it's undermining the safety and soundness of some of those institutions. I don't want to see that infect the commercial banking world in that way as I fear that it might under competitive pressures among States and among institutions.

That is a central, continuing issue that we have on our docket. Are our banks going to be able to go in the insurance business, which has been of some interest to you through the so-called South Dakota loophole?

What about underwriting, where some rather novel theories have been developed as to the application of Glass-Steagall in ways that probably were not contemplated by the Congress. We're having all kinds of new theories developed about how old law applies to present circumstances. We've had applications for underwriting everything from mortgage bonds, to revenue bonds, to corporate securities. We have the question of commercial paper.

I'm not saying all these things are bad. But I'm saying they're going to get decided one way or another without your input, unless you enact a law. Some of them may be fine and others may not. If you want to have an impact on this process, you're going to have to

act because otherwise it may be decided differently by different courts and by different regulators.

Senator DODD. I couldn't agree more with you and I don't want to sound a pessimistic note as we begin this new round of hearings, but it seems to me as you just pointed out, an awful lot of institutions that were in the past very supportive of actions being taken by the Congress, have decided to go off on their own, it's quite clear, to engage in other activities that they never imagined themselves being involved in, even as few as 6, or 7, or 8 months ago.

And I suspect that some of those very institutions that were arguing for legislation up here, may be the very institutions that are arguing against legislating up here because they're moving very quickly in their own regard.

Mr. VOLCKER. I think the consensus in the industry—it's hard to call it a consensus, but I think there is something of a consensus—is for action along the general lines contained in the legislation before you. I think there's more of a consensus in the interstate banking area than apparently members of the committee think.

But I think you have every opportunity to act this year and I would be much more optimistic than you are, but I think the situation is a mess as it stands.

Senator DODD. Just on the interstate banking issue—and I don't want to belabor that because you've addressed it pretty thoroughly here—but one of the things I think you've stressed over and over again is that radical change, dramatic change in a system without understanding fully the implications can be dangerous. And it was the feeling of many of us here that the regional approach would create that kind of spawning ground, move us away from the situation as it presently exists and create an environment where interstate banking becomes a possibility without the potentials that have been cited by Senator Proxmire and others. The statistics which cause many of us here to be alarmed about what may occur.

Are you really that deeply concerned about the regional approach for 5 years, as you've indicated in your testimony or, as a practical matter, don't you see it as a—

Mr. VOLCKER. Let me state the case.

I think the kind of concerns that Mr. Proxmire cites are more likely to materialize on a purely regional approach. Association bankers as a group favor an approach, I think, along the lines that we proposed.

Bankers individually sometimes want, as much as possible, a little private playpen of their own, a confined area insulated from competition from the outside to the extent possible, creating, I think, pressures toward more concentration in local markets than would otherwise be the case. That's the trouble with it—plus the inequities you get around the border. It's that tendency and pressure toward more concentration locally, within the region, not less, plus the inequities at the margin that I think argue that may be an acceptable and desirable transition arrangement but it shouldn't be the stopping place.

Senator DODD. But certainly you will recall as I do—I know in my own area, New England for instance, to even talk about a regional concept a few years ago was anathema. And yet we have found the very bankers that are opposed to the regional concept

are now arguing for it. And I think most parties—at least the one's I've talked to—understand the importance of reaching a stage very quickly to get to interstate banking, but in your point about the concentration of power and the parochialism is clearly one I would agree with. But we've seen that evolve; there is a change occurring, wouldn't you agree?

Mr. VOLCKER. You have some dominant banks in the New England region, looking just at that region. Is it really desirable, long-term policy that those dominant banks in the region become more dominant in that region without outside competition? I would say no.

Senator DODD. No; I agree with you.

The CHAIRMAN. Mr. Chairman, we've got other witnesses and want to move on.

Senator Cranston.

RESOURCES FOR NEW POWERS

Senator CRANSTON. In your judgment, Mr. Volcker, if Congress approved four or five of the new powers that are under consideration, apart from the Nation's large financial institutions, would medium and small institutions generally have the capital and capacity to put in place new operations to market and exploit those new powers?

Mr. VOLCKER. I think it depends upon the power. I think if you're talking about underwriting, for instance, small banks are not going to be interested in corporate underwriting, don't have the capability in the market and all the rest.

Not in the bill, but powers that have been debated—powers like real estate brokerage or insurance brokerage—are certainly powers that I think many small banks would and could and in some States do, exercise.

Senator CRANSTON. Thank you very much. Many in Congress have expressed concern that the money laundering cases that recently have come to light not only point to a gap in regulatory supervision of financial institutions, but also indicate a need for tougher legislation.

In response to a written question from me seeking your ideas on how to make compliance for the Bank Secrecy Act more effective, you recommended setting up an automatic surveillance system at Reserve banks to permit more timely detection of unusual cash activity at banks. What progress has been made in that area?

Mr. VOLCKER. We have been moving in the direction of changing some of our examination techniques. That is a device where you can pick up information; we are moving in that direction.

We found, I think as I indicated in a letter or some letters I have written to you, that the examination procedures did not pick up as much as they should have; cash transactions that didn't take place through the ordinary teller's window. The version of this was that you did a cash transaction across the tellers cage or you did it with foreign banks. Our examination procedures, I think, were adequate in those areas but there are some collection points in some banks that result in cash procedures, cash transactions, that weren't

picked up routinely in an examination effort, and we're trying to correct that.

Some of these procedures are done jointly by the different regulatory agencies. I don't remember precisely which of those procedures are common and coordinated, but in either case we will try to correct those gaps in the procedures.

Senator CRANSTON. In your response to the question of money laundering, you stated that any reporting exemptions given to depositors of cash should be approved by the bank's board of directors. In the *Bank of Boston* case, even though the bank was fined in a criminal proceeding for not following the law, the bank officers kept their jobs; their bonuses; their standing in the community, presumably, and half the profits from their illegal activity. The fine of \$500,000 did not equal the profits they made on their illegal transaction.

What are your views on making bank officials personally liable in situations like this and what are your views on legislation to impose higher penalties on banks that violate the law?

Mr. VOLCKER. Well, I would want to, I think, instead of responding right now, I would want to think about that a bit and consider precisely what the present law provides for, which I don't recall at the moment, and if I could give you a written answer, I would appreciate it.

[The following information was subsequently submitted for the record:]



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

June 3, 1985

The Honorable Alan Cranston
United States Senate
Washington, D.C. 20510

Dear Senator Cranston:

This is in further response to the question concerning penalties for money laundering that you raised during my recent testimony. You requested my views on making bank officials personally liable in situations such as the Bank of Boston case where a bank has not complied with the reporting requirements of the Currency and Foreign Transactions Reporting Act (31 U.S.C. §§ 1951-1959) (the "Act"). You also requested my views concerning legislation to impose higher penalties on banks that violate the Act.

At present, the Act provides for civil money penalties of not more than \$10,000 for any partner, director, officer, or employee of a domestic financial institution who willfully violates the Act or regulations implementing the Act. The financial institution is also subject to similar civil penalties. The Act also provides that where a domestic financial institution fails to maintain appropriate procedures to ensure compliance with applicable reporting requirements a separate violation occurs for each day the violation continues and at each office or branch at which a violation occurs or continues. Consequently, if properly applied, officers of a bank are exposed to substantial civil penalties for their willful violations of the Act.

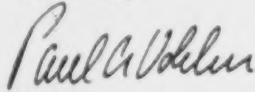
The Act also imposes significant criminal penalties on persons willfully violating its provisions. These persons may be fined not more than \$250,000, imprisoned for not more than five years, or both. If the violations occur as part of a pattern of illegal activity, the criminal fine may be up to \$500,000. As is the case with civil money penalties, a domestic financial institutions' failure to maintain appropriate procedures to ensure compliance with applicable reporting requirements would result in separate violations occurring each day the violation continues and at each office or branch at which the violation occurs or continues.

Senator Cranston

I would also note that the Comprehensive Crime Control Act of 1984 (Pub. L. 98-473) amended the Racketeer Influenced and Corrupt Organizations Act (18 U.S.C. § 1961 et seq.) ("RICO") to include violations of the Act within the definition of "racketeering activity" subject to RICO penalties. Violations of RICO can result in fines of up to \$25,000, imprisonment for not more than 20 years, and forfeiture of property involved in the RICO activity, as well as civil remedies.

The civil and criminal penalties provided for currently in the Act and in RICO appear adequate to impose personal liability on bank directors, officers, and employees guilty of willful violations of the Act. In appropriate circumstances, and properly applied, the penalties imposed can be quite substantial and act as a significant deterrent to willful violations of the Act by both banks and bank employees.

Sincerely,

A handwritten signature in dark ink, appearing to read "Paul C. Volker". The signature is written in a cursive, flowing style with a large initial "P".

Senator CRANSTON. Fine.

If the committee does not see fit to authorize regional banking with a trigger, would you then oppose the title on regional banking in S. 2851?

Mr. VOLCKER. I would, yes.

Senator CRANSTON. Thank you very much.

The CHAIRMAN. Mr. Chairman, we appreciate your patience and I know we've taken you overtime, but I promised Senator Riegle that he could ask one more question before we move on.

Senator RIEGLE. Just a very brief comment and perhaps the Chairman would want to make a response. I'm a great admirer of his, as he knows, and I've stated that many times.

I agree with you that I think we need legislation this year; I think we needed it last year. We didn't get it but I think the likelihood of getting it depends a lot about whether we're talking about a narrow bill or a great big broad bill. And if we're going to have a great big bill we may have no bill at all and we may be floundering for another year here.

SAFETY AND SOUNDNESS ISSUE

But I think the safety and soundness issue, which I can understand why you're reluctant to talk about it in detail, I think there's a great concern about it and not just here in the Senate but in the House as well. And if we're going to pass legislation we're going to have to, I think, more fully illuminate the question of where the system is at this point and if you don't feel you can talk about that fully here in a public setting, then we're going to have to talk about it privately somehow because it's a concern I have and I can just tell you it's widely shared.

Mr. VOLCKER. I wasn't conscious of evading any questions on that score and I would simply repeat that my principal focus in looking at this legislation is how it protects the safety and soundness of the system. There are some very important considerations that arise there, and that's part of the reason I want this legislation.

Senator RIEGLE. But then I think we have to have an understanding as to the starting point. Where are we today in terms of safety and soundness and I don't think that should create undue awkwardness to try to at least frame out what today's reality is and to have some—maybe we agree on it, maybe we disagree on it—but the Congress wants to understand that better and, you know, you're one of the few people that can help us understand it.

The CHAIRMAN. If I can just respond, Senator Riegle. There's no one on this committee that is more concerned than I about safety and soundness. Senator Proxmire knows, he's been chairman, and when you're chairman it places additional responsibility on you.

And so over the years I've watched that very, very closely. Every time the question has been brought up usually by critics that you and I know very well, that if they don't want some changes they almost always use the safety and soundness issue as the reason that we should not do anything.

So with the bank failures, I have spent a good deal of time looking at them to answer that very question. With the big ones, it's easy. With Continental Illinois, there's really no connection what-

soever to what we've done or what we've proposed to do; this also includes Penn Square and the Jake Butcher situation.

But I've gone further into it and I've looked at virtually every single bank failure, the 79 that occurred last year. I can find no connection with the failures to what we did in Garn-St Germain or what we proposed.

And I agree with Chairman Volcker. I would not propose anything in legislation that I thought would contribute to that problem bank area.

So in response to that, when you say we should have a narrow bill, that has been one of my most difficult problems. Last year it was and I had to talk to a lot of our individual colleagues on the floor to show them that it was a very narrow bill in terms of powers.

We granted two new powers in that bill, municipal revenue bonds and mortgage-backed securities, period. We also ratified commercial paper and discount brokerage, which the institutions are already doing.

So the rest of the bill, other than regional banking, was not controversial; it was not really discussed in the committee; it was not debated on the floor. Regional banking was over the powers and that was essentially the controversial part of the bill.

Not just for your benefit but Senator Riegle, as ranking minority member at the tail end of Garn-St Germain, was very, very helpful and understands these problems extremely well.

But I do think that although it's a comprehensive bill and touches on a lot of areas, it really is narrowed down to the controversy over regional banking and over the powers. I just have to emphasize that we eliminated for that very reason last year, insurance and real estate powers. With the things that went—whether it was a legitimate argument or whether they were bank related, it was narrowed down to mortgage-backed securities and to municipal revenue bonds as the only two totally new powers that were not granted.

So I don't think we necessarily agree. Certainly we're not very far apart. But to me that is a narrow bill with the granting of only two powers. Yet, every place I go, you can't imagine the things that I hear about what was in S. 2851.

We're going to allow banks to run caterpillars up and down the street and be contractors and you name it, and sell sewing machines and furniture in their lobbies to compete with Sears. I'm amazed at what I hear about what was in that.

Mr. VOLCKER. I didn't know whether Senator Riegle was thinking of your bill as a broad bill or a narrow bill, but I certainly think it's got some provisions—which we, of course, would like to see strengthened—that are of positive assistance in dealing with prudential problems and that would support the effort to improve the safety and soundness of the system—particularly, but not exclusively, the provision you already have in there about State powers.

I'd like to see you go a little further in that area, but I think you could go into other powers that would raise—I'm not saying you're going to—that would raise no question in my mind of adverse safety and soundness consequences that are not covered in this bill.

Senator PROXMIRE. If the Chairman would yield.

This bill passed the Senate 89 to 5, overwhelmingly. It seems to me the logical thing to do is to introduce the same bill and go through it again. If the Senate approves it, why tinker with it.

Mr. VOLCKER. I hope you don't exclude the possibility of making my improvements in the bill; that might pass by 88 to 6, and that would be perfectly satisfactory.

Senator RIEGLE. Well, we don't want to just pass the bill in the Senate every year for the next 10 years and enact no changes in law. I mean, you know, the whole point of this exercise is not to pass the Senate even if it's 100 to 0 if we can't do something with the House and put it on the President's desk, we haven't done anything but lose time.

And so sometimes having, whether one calls it broad or narrow, a bill that can pass both bodies and become law, is preferable to having something that might be more perfect but never sees the light of day in terms of the finished product.

The CHAIRMAN. Well, let me just assure Senator Riegle and the committee that I have no intention in this bill or in the future of putting things into it that I think endanger safety and soundness; they just won't be there and that is why even though I would agree with the Chairman, there are some things that I personally did not consider safety and soundness items last year, but were removed because other people did.

To narrow that is to attempt to limit that argument that some people make. But I'm not going to push for a bill—I'm sure Senator Proxmire is not either—that compounds the problems of troubled banks.

I think the questions Senator Riegle brings up are right at the core of the issue. It's a line we have to draw to make that determination and learn as much as we can about the problem banks.

I think it would be helpful, Mr. Chairman, if you could supply, not only for Senator Riegle but for the whole committee, any analysis on the banks which you have done. I have not written down anything as I have looked into these failed banks and the reason for them. But I don't think it's sufficient to say that it is my feeling that they have not. If you can supply us with some objective data for the committee for the record, I think that would be helpful.

Mr. VOLCKER. We can certainly do that.

[The following information was subsequently supplied for the record:]

Chairman Volcker subsequently submitted the following responses to written questions from Chairman Garn: (5/8/85 hearing)

Question: Please provide to the Committee an analysis of bank failures over the last three years as well as a forecast of the number of future bank failures. Would the authority to underwrite municipal revenue bonds have exacerbated those bank's problems?

Answer: State member banks represent 10 of the 177 bank failures from 1983 to date. The enclosed schedules provide a brief description of each of these state member bank failures. We see no indication that any of these failures would have been accelerated by the authority to underwrite municipal revenue bonds. A total of 79 banks failed in 1984 and as of June 20, 1985, 50 have failed during 1985. In recent announcements the FDIC has stated that failures in 1985 will most likely exceed those in 1984.

STATE MEMBER BANK FAILURES
1983, 1984 and Year-to-Date 1985
As of June 30, 1985

BANK A

Assets less than \$10 million

A poor local economy and unsound lending practices resulted in a high volume of poorly structured loans which included loans to principals, officers and directors. The resulting high loan losses coupled with expensive funding and high overhead caused the bank's insolvency.

BANK B

Assets less than \$50 million

Bank opened for business in 1981 and embarked on a policy of rapid growth funded by volatile liabilities. During the eighteen month period from December 1982 to July 1983 assets grew from \$50 to \$73 million. Concentrations of credit to high risk venture capitalists and insider abuse in the form of lending to principals, officers and directors quickly led to erosion of asset quality and capital.

BANK C

Assets less than \$25 million

The failure of the bank is primarily attributable to mismanagement and poor local economic conditions. Under the leadership of the former president the financial condition of the bank quickly deteriorated as the following unsafe and unsound practices were undertaken:

- 1) lending for speculative purposes to out of area borrowers;
- 2) ineffective credit administration and lax collection efforts;
- 3) insider abuse in the form of Regulation O violations; and
- 4) transfer of poor quality assets between affiliates.

Aggressive lending practices, particularly in the area of real estate development, combined with 20% local unemployment during the recession led to excessive loan losses and depletion of the bank's capital accounts.

BANK D

Assets less than \$25 million

Negligence by senior officers and the board of directors permitted the following unsafe and unsound practices:

- 1) rapid growth funded by brokered deposits;
- 2) concentrations of credit to specific customers and industries;
- 3) lax and ineffective collection policies; and
- 4) possible collusion and fraud by an officer.

These practices resulted in a substantial volume of real estate development loans which, coupled with unfavorable local economic conditions, later deteriorated in quality and resulted in losses. One construction loan accounted for 72% of the loan losses that caused the bank's demise.

BANK E

Assets less than \$10 million

Aggressive lending philosophies resulted in the bank's loan portfolio being comprised primarily of unsecured commercial loans (60% of total). Management failed to properly analyze the repayment sources and financial strength of obligors and, in many instances, failed to even obtain financial information. In addition, a number of large unsecured credits were purchased from an affiliate and lacked adequate documentation. Subsequent deterioration in local economic conditions caused a decline in the financial strength of many creditors yet management did not take appropriate steps to protect its interests by obtaining collateral or restructuring repayments. The end result of this inadequate loan administration, liberal credit advances and economic downturn was large loan losses which caused the bank's insolvency.

BANK F

Assets less than \$25 million

The bank's failure is ultimately attributable to management's failure to adequately respond to the economic conditions of its community and adopt and adhere to sound lending policies. During the past recession unemployment in the bank's market ran as high as 30%. The local economy was primarily agrarian with only one large employer. In the late 1970's, management made numerous loans based on escalating land values with little regard for economic prospects and ultimate repayment. When inflation abated in the early 1980's, the value of the underlying collateral decreased substantially and left the bank with numerous loans for which neither repayment sources or collateral margins existed.

BANK G

Assets less than \$60 million

The failure of the bank is attributable to the liberal lending policies of three lending officers. Under their detrimental influence, the following unsafe and unsound lending practices were permitted:

- 1) lack of financial information on borrowers,
- 2) lack of adequate financial analysis of borrowers,
- 3) lack of realistic repayment programs, and
- 4) lack of adequate collateral support.

Accordingly, significant asset deterioration resulted. In addition, alleged fraud perpetrated by the three officers magnified loan losses and caused the bank's insolvency.

BANK H

Assets less than \$10 million

Inadequate supervision by the board of directors enabled the executive vice president to engage in hazardous lending practices which, combined with poor local agricultural conditions, led to significant asset deterioration (agricultural loans comprised 22% of the bank's loan portfolio). The resulting loan losses coupled with fraud perpetrated by the executive vice president caused the bank's insolvency.

BANK I

Assets less than \$110 million

The failure of the bank is attributable to the aggressive lending philosophy of senior management which permitted the following unsafe and unsound lending practices:

- 1) lending for venture capital purposes;
- 2) lending for speculative purposes to out of area borrowers;
- 3) concentrations of credit to specific customers and industries;
- 4) lack of analysis of repayment sources;
- 5) lack of adequate collateral support; and
- 6) insider abuse in the form of transfers of poor quality assets between affiliates.

Accordingly, asset quality deteriorated and resulted in excessive loan losses and depletion of the bank's capital accounts.

BANK J

Assets less than \$50 million

The bank's failure is primarily attributable to a series of fraudulent real estate transactions executed by means of collusion between the former bank president and a local real estate developer. In addition, the liberal lending philosophy of the former president permitted the following unsafe and unsound lending practices:

- 1) extending credit in amounts exceeding the legal lending limits;
- 2) lending without adequate documentation;
- 3) making loans without adequate collateral; and
- 4) lending without adequate analysis of sources of repayment.

Question: Many analysts claim that commercial and personal loans are in the process of being "securitized." They point to commercial paper, mortgage-backed securities, auto loans, and junk bonds. They predict that this trend will increase. Do you agree with this analysis and forecast? If so, what does this imply for the future earning capacity of bank holding companies?

Answer: Over the past 20 years, financial markets have become increasingly sophisticated, with new products and innovations blurring the traditional delineations among sources and types of credit. Since the 1960s, large businesses have been able to raise short-term funds directly in the commercial paper markets, thus reducing their reliance on commercial bank lending. Facilitated by the growth of third party guarantees--including letters of credit provided by banks--the market for commercial paper has grown rapidly in recent years providing access to the capital markets for a wider variety of business borrowers. The volume of low and unrated securities ("junk bonds") also has surged, as underwriters have more actively marketed such issues and as investors appear more willing to lend directly to less well-known borrowers whose credit history perhaps is untested. An important further development has been the rapid expansion of the mortgage-backed securities market, and more recently the issuance of securities against pools of automobile and commercial loans. The marketability of these securities frequently is enhanced by financial guarantees issued by the originator of the loan or by third parties.

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In concept, these innovations can provide some benefits for borrowers and lenders. In concept, the "securitizing" of debt tends to eliminate differences in financing costs among geographic areas or segregated groups of savers and investors. Banks and other institutions that make commercial or personal loans can, by selling loans or issuing securities against pools of loans, increase the liquidity of their portfolios. To the extent such instruments provide more flexibility for controlling the proportions of assets in different borrower and maturity categories, they allow lenders to better diversify risk. To the extent there is pressure on "spreads" between the interest rates received by the ultimate lender and paid by the ultimate borrower, borrowers would appear to benefit.

There are, nonetheless, many uncertainties and new risks associated with the securitizing of debt that raise concerns about their implications for risk taking. The origination of loans is separated from the actual lending of funds, with third parties often insuring the loans. When loans are packaged together, there are generally still other firms doing the loan packaging or holding the loans in escrow or as trustee. This may tend to encourage sloppy procedures and inadequate loan evaluation as each party relies on others to investigate the loans thoroughly. Furthermore, ultimate purchasers of the securities, who sometimes bear the most risk, may lack the expertise and information to make proper investigations.

While these risks appear limited with standardized mortgage instruments with relatively objective and conservative underwriting standards, they could become greater in other areas. One solution for lenders is to require a residual guarantee by the originator. For example, a bank may commit to replace all loan losses up to 10 percent of the loans sold. But, as bank regulators, the Federal Reserve has some concern about how banks account for such transactions and whether the risks are fully recognized. With the exception of certain mortgage pool transactions, the Federal Reserve's position and that of other bank regulators has been that loans sold with recourse to the originator or its affiliate should be classified as collateralized borrowings, not as asset sales. Otherwise, such loan sales could be too easily used to keep risk off balance sheets and distort capital ratios without an equivalent reduction in real risk taking. Federal Reserve examiners have detailed instructions to take all off-balance sheet risks into account when evaluating the capital adequacy of an institution.

As the innovative process continues, banks along with other lenders will adopt lending policies and services to accommodate changing demands by borrowers. The implications of these changes for their future earnings capacity are difficult to assess. Increased competition for lending to banks' traditional customers could lower interest margins on business and

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personal loans. If this process results in improved liquidity and maturity matching, and in some credit risk being shifted from banks and their holding companies to other lenders and investors, lower profit margins would conceptually be commensurate with reduced risk of bank portfolios. The clear danger is that competitive pressures may lead to squeezes in profit margins without commensurate reductions in risk.

Over time, one implication is that fee income may become a more important source of revenues as banks become more involved in the origination and servicing of pools of assets and in the issuance of financial guarantees to back commercial paper or to insure payment on asset-backed securities. The question is whether the fees are commensurate with the risks-- or whether, conversely, the buyer of securitized loans may be assuming more risk than he recognizes at the outset.

Question: Mr. Budd of Travelers Insurance Company testified that it would have been irresponsible for Travelers not to have activated its bank charter in view of the thrust and strategic announcements that many of Travelers' competitors have made. Given the changes occurring in the financial services marketplace, would it be irresponsible not to permit banks and bank holding companies to respond to the marketplace and their competitors by expanding their product lines to the extent you have suggested in your testimony? What are the risks to the financial system as a whole and banks specifically, if Congress does not authorize product and service flexibility?

Answer: As my testimony reflects, the Board believes that it is in the public interest to permit banking institutions to respond to the needs of consumers and business for a broader range of financial services where the provision of those services is consistent with safety and soundness and avoids conflicts of interest and concentration of resources. It is the responsibility of the Congress to provide an appropriate framework for the expansion of bank holding company powers that balances this objective with other public policy concerns: assurance of fair and open competition in the provision of credit and other services, maintenance of impartiality of banks in credit judgments, and avoidance of practices that can undermine the strength of the bank itself or the banking system.

If Congress fails to act, financial institutions--both banking and nonbanking--as recent experience shows, will

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respond to market demands and competitive pressures by developing and exploiting loopholes in the law. As a result, important questions of public policy will be decided in a haphazard manner with potentially dangerous consequences for our nation's banking system. The appropriate framework for the nation's banking system, which is critical to the health of the nation's economy, is too important to be left to evolve in such a haphazard manner. I do not believe that is a responsible approach. And I also believe that some product line flexibility for banks -- within limits I outlined in my testimony -- would be consistent with some limited reduction in risks in the banking system. Other factors, however, are likely to be more important -- not excluding other institution's "skimming off," through nonbank banks or otherwise, portions of the banks franchise without equivalent responsibilities.

Question: Mortgage credit in this country once was provided almost exclusively by traditional depository institutions that held mortgages until their maturity. Today, more and more mortgages are sold to investors in the secondary market.

A similar development has occurred in the provision of commercial credit. Whereas commercial banks were once the almost exclusive providers of commercial credit, the commercial paper market has enabled corporations to acquire commercial credit by selling their debt directly to investors.

Would you agree that explicit authorization for banks to underwrite mortgage backed securities and commercial paper is needed to preserve their traditional role in the provision of mortgage credit and commercial credit? Why?

Answer: As a preliminary comment, I should point out that a significant volume of commercial and mortgage credit have already been supplied by non-depository institutions, including trade creditors. It is, of course, true that market developments for some time have encouraged the provision of such credit activities by other than depository institutions.

For instance, because it is often easier and cheaper for businesses to raise short-term funds in the commercial paper market, especially for the most creditworthy businesses, a significant amount of the commercial loan business of banks has been diverted to the commercial paper market. Indeed, relative to the increase in commercial and industrial loans at commercial banks, the commercial paper market has experienced dramatic growth. Currently, many of the nation's most creditworthy borrowers use the commercial paper market to

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obtain short-term, working capital rather than the traditional source of such funds, loans from commercial banks. For example, recent studies have indicated that for United States manufacturing firms with assets of \$1 billion or more, the share of bank loans in the firms' short-term liabilities has declined from 56 percent in 1973 to 17 percent in 1983, while the share of commercial paper issued by these firms has increased from 33 percent to 40 percent during the same period. Permitting banking organizations to place commercial paper on behalf of issuers allows them to maintain business relationships with their best loan customers and allows participation by banking organizations as intermediaries in a short-term credit market, a traditional field of expertise for commercial banks.

Similar reasons support permitting banking organizations to serve as intermediaries with regard to mortgage-related securities. In recent years, the issuance of securities representing interests in pools of mortgages has become an important method of achieving liquidity in the market for mortgages on residential real estate. Although banks are now expressly authorized to underwrite and deal in mortgage-related obligations issued or guaranteed by federally-chartered agencies, such as the Government National

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Mortgage Association, this authorization does not extend to privately issued mortgage-backed securities, which according to some current estimates comprise about 15 to 20 percent of the secondary mortgage market. The private mortgage-backed security market is expected to increase its growth, and bank participation is appropriate in order to assure that funds continue to be available to finance housing.

The Board has supported legislation that would authorize banking organizations, under appropriate safeguards, to underwrite commercial paper and residential mortgage-related securities. Banking organizations have the necessary expertise to engage in these activities, and the conduct of these activities does not give rise to excessive risk, undue conflicts of interest, or unsafe or unsound practices, provided they are conducted with clear understanding of the risk involved and under appropriate guidelines.

Question: Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment activities than commercial banks in the U.S.

Are you aware of serious safety and soundness problems that have arisen from this combining of investment banking and commercial banking in London?

If a financial institution in London can offer both commercial and investment banking services to a corporate customer, does that financial institution in London have a competitive advantage over a financial institution in the U.S. that can offer only one of the services?

Answer: Until recently, major domestic commercial banks in London have not engaged in a general line of investment banking activities on any scale. That tradition appears to be in the process of change, but it is far too early to make any generalizations about the implications for safety and soundness. So called "merchant banks" and some foreign banks have long combined deposit-taking with investment handling activities. The degree of risk in such conduct is dependent in major part on the traditions of the market and supervision.

Member banks and holding companies have long been permitted to engage overseas through Edge corporation subsidiaries in a broad range of activities that are considered usual in connection with banking or financial operations outside the United States. These activities sometimes go beyond what is permitted to banking organizations in the United States. The purpose of this latitude is to enable U. S. banks

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to compete more effectively with local banking organizations abroad that are not subject to the U. S. policy framework for the conduct of banking. Congress has determined that U. S. banking organizations should have in their foreign operations "...powers sufficiently broad to enable them to compete with similar foreign-owned institutions in the United States and abroad." 12 U.S.C. § 611a. It is in this context that U. S. banking organizations are permitted to engage in some investment banking activities outside this country. With respect to safety and soundness, there have been no significant problems encountered thus far although, as in any activity, some relatively small losses have been suffered and activities of significant size are of relatively recent origin. These operations are, of course, subject to local supervision and regulation as well as to the supervision of U. S. authorities. No studies have been made to our knowledge of the impact of these operations on the problems of conflicts of interest and concentration of resources.

With respect to the question of competitive advantage, any time an institution can offer more services than a competitor, there will be an advantage. However, in the United States, foreign banks must operate under the same rules that apply to U. S. banks in the area of investment banking and therefore do not enjoy a competitive advantage in this

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respect. Congress has determined that commercial and investment banking should remain separate in this country in order to maintain banks as impartial providers of credit and to avoid the "subtle hazards", as recently described by the Supreme Court, that can result from a combination of these activities. The Board has supported legislation that would permit U. S. banking organizations to engage in certain securities activities, e.g., underwriting municipal revenue bonds, commercial paper and mortgaged backed securities because the Board believes that the special characteristics of the market for these instruments is such as to avoid the adverse effects arising from the potential for conflicts of interest and concentration of resources inherent in combining investment and commerce banking. Because it is mindful that the potential for conflicts of interest and other adverse effects is real, the Board has not advocated allowing banking organizations to offer the full range of investment banking services, especially the underwriting of corporate debt and equity securities.

Question: In your testimony, you recommend that joint marketing of products by thrifts and their affiliates be prohibited for products not permitted to bank holding companies. Are you concerned about the competitive disadvantage of bank holding companies?

Answer: My testimony recommends that joint marketing operations between FSLIC insured thrifts and their affiliates be prohibited if such affiliates engage in activities impermissible for multiple savings and loan holding companies. The activity restrictions on multiple savings and loan holding companies are similar to those applicable to bank holding companies under the Bank Holding Company Act. My concern in making this suggestion is to prevent the unitary savings and loan holding company exemption from becoming a device similar to the nonbank bank loophole through which nonbanking companies can evade the national policy of separating banking and commerce. The purpose of the unitary exemption is to provide a limited exception to that policy in order to provide additional sources of financial support for home lending institutions. The Board believes that the exemption should be applied in a manner that accomplishes that objective without risking the conflicts of interest, unfair competition, and other adverse effects that the policy against commingling banking and commerce is designed to prevent. The competitive disadvantage of bank holding companies adds to these more general concerns.

We therefore support a tandem operations restriction in order to insure that the unitary exemption is limited to those companies that operate their subsidiary savings and loan association independently from affiliates engaged in impermissible business activities and do not use their subsidiary thrift institution to enhance those business activities.

Question: We all know that thrifts originally suffered when interest rates shot up and they were holding fixed-rate mortgages. The decline of interest rates and the ability to offer interest-sensitive assets has helped restore many thrifts to a healthier condition. However some thrifts are now suffering from asset quality problems.

As we move to interstate banking, how can we afford to severely limit the potential acquirers of troubled thrifts?

What advice would you give the Congress in managing the present thrift problems?

Answer: The Board has supported legislation that would increase the number of potential acquirers of thrifts by specifically authorizing bank holding companies to acquire savings and loan associations. A broader interstate banking authorization is likely to increase the number of eligible and potentially interested buyers. The question sometimes raised, however, is whether their buying interest would be diverted to "healthy" thrifts and banks. It is not possible to estimate with accuracy where the balance would lie on a national basis, but the policy gains from permitting competition on a broader basis suggests that it would be most worthwhile to proceed with a staged expansion of interstate activities for both banks and thrifts.

While the Board has authorized bank holding companies to acquire failing thrifts, the Garn-St Germain Act of 1982 allows such acquisitions only when the FSLIC determines that "severe financial conditions exist which threaten the stability of a significant number of insured institutions, or of insured institutions possessing significant financial resources." The Act also establishes an elaborate system of priorities in the

acquisition process, in which acquisitions by bank holding companies have a rather low ranking. The Act similarly authorizes interstate acquisitions of failing banks, but only when the FDIC has closed the bank and the bank has total assets of at least \$500 million. In order to encourage acquisitions of failing thrifts, as well as failing banks, Congress might wish to consider broadening the circumstances under which such acquisitions may be authorized.

The current problems of thrift institutions are increasingly credit problems relating to the quality of thrift assets. This problem can be ameliorated through stronger supervision and tighter limitations on thrift investments. The recent rules of the FHLBB to monitor more closely equity investments of thrifts in real estate, service corporations, and equity securities above threshold levels, and to increase thrift net-worth requirements based on growth in thrift liabilities, should lead to improvements in the overall condition of the thrift industry. Limitations on state authorized activities of federally insured thrift institutions, particularly real estate development, also are necessary to insure that thrift involvement in these activities with appropriate safeguards do not further undermine the health of thrift institutions.

Chairman Volcker's response to a written question from Senator Gorton: (5/8/85 hearing)

Question:

I am told that a majority of failed banks had "CAMEL" ratings of 1 or 2 on the call report most immediately preceding their closure. If true, this has profound implications for the ability of bank examiners to spot and deal with problems. Can you confirm this allegation? Can you supply for the record what the CAMEL ratings were for those banks under your jurisdiction which have failed on the call report immediately preceding their failure? How do you explain those instances where the previous exam did not disclose the institution's danger of failure?

Answer:

The majority of failed state member banks from 1983 to date were rated 4 or 5 on the examination report most immediately preceding their closure. The remaining failed banks were examined and rated by either the Comptroller of the Currency, in the case of national banks, or the Federal Deposit Insurance Corporation in the case of State nonmember banks. It is our understanding that a majority of these banks also had "CAMEL" ratings lower than 1 or 2 on the examinations immediately before their closing.

Of the total of 177 bank failures during 1983, 1984 and year-to-date 1985, 10 were State member banks. The "CAMEL" ratings from the three examinations prior to the closing of each State member bank during 1983, 1984 and year-to-date 1985 are provided in the attached schedules. Of the ten State member banks closed during this period all but one were rated "CAMEL" 3, 4 or 5 prior to the examination that resulted in their closing (see BANK E: attached schedules). There was only one failure in which the bank was rated higher than "3" immediately before closure. In that case, the sudden and drastic decline in the bank's condition was attributable to a significant volume of poor quality assets transferred to the bank by an affiliate just prior to the examination that revealed its insolvency and resulted in its closing. In all other instances the deteriorated condition of the banks was in fact revealed by the examination process well in advance of their closing, and supervisory actions were taken.

STATE MEMBER BANK FAILURES
1983, 1984 and Year-to-Date 1985
as of June 20, 1985
Date of Closing and Prior CAMEL Ratings

BANK A: Closed March 1983

Prior CAMEL Ratings

Composite 5

Composite 4

Composite 4

Date of Examination

March 1983

October 1982

March 1982

BANK B: Closed May 1983

Prior CAMEL Ratings

Composite 5

Composite 5

Composite 4

Date of Examination

March 1983

October 1982

May 1982

BANK C: Closed February 1984

Prior CAMEL Ratings

Composite 5

Composite 5

Composite 4

Date of Examination

July 1983

February 1983

July 1982

BANK D: Closed February 1984

Prior CAMEL Ratings

Composite 5

Composite 4

Composite 4

Date of Examination

January 1984

September 1983

February 1983

BANK E: Closed May 1984

Prior CAMEL Ratings

Composite 5

Composite 2

Composite 1

Date of Examination

April 1984

April 1983

November 1981

BANK F: Closed June 1984

Prior CAMEL Ratings

Composite 5

Composite 5

Composite 4

Date of Examination

November 1983

February 1983

May 1982

BANK G: Closed September 1984

Prior CAMEL Ratings

Composite 5
Composite 5
Composite 5

Date of Examination

September 1984
April 1984
July 1983

BANK H: Closed December 1984

Prior CAMEL Ratings

Composite 5
Composite 5
Composite 5

Date of Examination

August 1984
March 1984
December 1983

BANK I: Closed January 1985

Prior CAMEL Ratings

Composite 5
Composite 3
Composite 3

Date of Examination

December 1984
December 1983
October 1982

BANK J: Closed March 1984

Prior CAMEL Ratings

Composite 5
Composite 5
Composite 5

Date of Examination

June 1984
December 1983
July 1983

The CHAIRMAN. I'm just expressing opinions. OK, this bank failed, why did it fail and if we granted municipal revenue bonds would that have accelerated their problem? Does it have anything to do with it? I think that would be very helpful and the Senator makes a good request.

Senator RIEGLE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Mr. VOLCKER. Thank you.

The CHAIRMAN. Next, I'd like to invite from the witness table, Bill Isaac.

I understand Chairman Isaac is in the hallway, if someone will ask him to come in.

[Pause.]

The CHAIRMAN. Before we start, may I, I failed to do so, to thank Chairman of the Fed and all the witnesses today for rearranging their schedule. We did impinge upon Chairman Volcker, and that's why we had to refrain from second rounds of questioning. The reason we had to cancel last week was entirely my problem, a personal one, with a daughter and a new grandchild. For those of you who were aware of that, I would report that not only is my daughter doing fine, the baby is very tiny and will probably have to live in an incubator for the next month, but she's doing fine. And I don't have any doubts that she's going to make it.

But, the point I wish to make is, I thank all of you for rearranging your schedule on such short cancellation notice last week and being willing to reschedule today. I could have been here. The father of the baby was there. I don't know that the grandfather needed to be there that morning, but I really couldn't have asked questions about Glass-Steagall at that time [laughter] couldn't have been too interested in what was going on.

Please proceed.

WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Thank you, Mr. Chairman. May I ask that my full statement be put in the record, so that I don't have to read it to you?

The CHAIRMAN. We will have no objection to that.

Mr. ISAAC. Thank you.

Mr. Chairman, I would really like to express appreciation to you and to members of this committee for the tireless effort you have made to try to bring about comprehensive reform in the banking area, to push a comprehensive deregulation bill.

You did adopt one last year, and that bill was a very good beginning. I hope you don't lose patience because this is an important subject and one that I think we need to keep on—

The CHAIRMAN. If I could have one space flight a year to brighten up my year, I could be very patient in between. [Laughter.]

Mr. ISAAC. The bill last year did a number of very good things and some things that concerned us.

BILL WAS REGRESSIVE IN INSURANCE AREA

The things that concerned us about last year's bill were that in the insurance area, we felt that it was regressive. It took away too many powers in the insurance area.

If it were to become law, it would hurt our efforts in containing broker deposits. Last year's bill could have been substantially improved in the area of broker deposits.

And, also, it would have expanded the Net Worth Certificate Program to include agriculture banks, something that we think would be very detrimental to the banking system, to the FDIC and to the agricultural communities.

In terms of where we ought to be going this year, I would hope that we could use last year's bill as a starting point and find ways to broaden it to give banks broader powers in the securities, real estate, and insurance areas than were contained in last year's bill.

I would hope that we could look at deposit insurance reform and some of the critical issues that are before us in that area, such things as risk-related premiums, a ban on State insurance systems, the possible merger of the FDIC and the FSLIC to strengthen the Federal insurance system, and geographic restraints.

It's a very big agenda we have before us. I commend you for holding these hearings, and I'll be happy to respond to any questions.

[The complete prepared statement follows:]

STATEMENT ON

LEGISLATIVE RESPONSES TO CHANGES
IN FINANCIAL SERVICES

PRESENTED TO

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

BY

WILLIAM M. ISAAC
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

10:15 a.m.
Wednesday, May 8, 1985
Room SD-538, Dirksen Senate Office Building

Mr. Chairman, last year the Senate voted overwhelmingly in favor of the banking bill reported out of this Committee. Due to the circumstances well known to you, however, it did not become law. You have asked that we now comment on current conditions that might dictate changes in that bill. I am pleased to have the opportunity to do so.

In recognition of the need for deregulation of bank liabilities to be accompanied by commensurate liberalization of assets and services, last year's bill had as its basic theme enhanced investment opportunities for commercial banks. Although it did not go nearly as far as we would have liked, the bill would have provided new earning opportunities for banks by permitting them somewhat greater freedom to compete in financially related services. The American public would have been served by the improved competitive climate.

The events of the last year are fairly well known to members of this Committee. I will merely give you my assessment of their significance and how I think they might affect your legislative priorities.

A. Bank Failures. Bank failures have continued at a high level by historical standards, reaching 79 in 1984. During 1985, they will almost certainly exceed that level. Most have been smaller institutions. However, the near failure of Continental Illinois demonstrated once again that large banks are not immune to problems, particularly where unit banking laws limit the ability to establish a strong base of core deposits. Many of the small bank failures, particularly in agricultural states that restrict branching, are due in some measure to their inability to diversify their portfolios.

B. Thrift Problems. A number of mutual savings banks remain in critical condition and are dependent on net worth certificates for their survival. We have no serious objection to the renewal of this program for thrifts, provided thrifts are mandated to conform over time to the capital standards and accounting rules applicable to banks. We strenuously oppose any extension of the net worth certificate program to shareholder-owned commercial banks for reasons set forth in testimony before Senator Gorton's Subcommittee two weeks ago.

The failure of Home State Savings and Loan in Ohio and the subsequent holiday imposed by Governor Celeste on 71 state "insured" savings and loans raise another question -- namely, is it in the public interest to continue allowing state deposit insurance companies to function? We believe public confidence, both here and abroad, has been shaken by the Ohio episode. Many innocent people in Ohio, Tennessee and Nebraska have lost or may well lose their life savings as a result of failures of non-federally insured institutions in the past two years. In addition, an uninsured institution that held itself out to the public as a bank failed recently in Iowa, victimizing thousands of people.

We favor a new definition of the term "bank." Simply put, our preferred definition would provide that if an institution holds itself out to the public as a "bank" by using that word in its title and accepts deposits from the public, it must be insured by the FDIC, regulated as a bank and subject to the Bank Holding Company Act. Not only would this provision help prevent a recurrence of the recent tragedies in Ohio,

Iowa, Nebraska and Tennessee, it would close down the nonbank bank loophole and reduce the incentive for forum shopping by institutions seeking to avail themselves of the more liberal prudential standards applicable to savings and loan associations while still calling themselves banks.

C. Court Decisions. Recent court decisions have adversely affected our efforts to control some risks that we consider very serious threats to the deposit insurance fund. Although insured brokered deposits have greatly increased losses in failed banks, our effort to limit this abuse by regulation has been struck down by the courts, though we intend to pursue all avenues for appeal.

The FDIC has never considered letters of credit as deposits, but in two recent lawsuits, most notably the "Philadelphia Gear Case," the courts have found the FDIC liable for letters of credit as deposits. This poses multiple problems for the FDIC and banks. The FDIC fund will be exposed to substantial potential liabilities. Banks will see a significant increase in their deposit insurance premiums.

D. State Initiatives. The states continue to lead the way in updating laws governing the financial services industry. Apparently the conflicting lobbies that immobilize the Congress do not have the same impact on some state legislatures. A number of states have authorized new investment powers for banks and thrifts. Regional compacts to authorize limited interstate banking have been enacted, or are under active consideration, in many areas. Lacking any Congressional direction, the FDIC has proposed rules regarding the exercise of new powers

by insured banks. The proposed rules are designed to protect consumers as well as to contain risks to the insurance fund from possible unsafe and unsound practices. These rules will be reissued for further comment in the near future.

Any consideration of developments in the financial services markets would be incomplete without recognizing market developments that are taking place without the benefit of any legislation. Interstate ATM networks are spreading everywhere, providing consumers with banking services twenty-four hours a day, at home and away. Money market mutual funds continue to compete for savers' funds, and investment bankers compete fiercely for IRA and Keogh funds on a fully insured basis. I could go on.

What this means is that the only financial intermediaries constrained in any way by the Glass-Steagall Act, the Bank Holding Company Act or the McFadden Act are bank holding companies and commercial banks. One has to wonder why commercial banks, which are so essential to the delivery of financial services, cannot provide a full range of financial services or must resort to uneconomical legal devices in order to provide them.

Events of the past few years clearly point to the need for improvements in the deposit insurance system. I can report to you that we have done a number of things administratively to improve our operations. We have implemented new reporting requirements and improved information retrieval systems to enable us to spot developing problems with our

off-site monitoring system. We imposed new disclosure requirements so investors and bank customers can assess the quality of their banks.

We have issued a greater number of supervisory actions to correct unsafe practices, we have increased capital requirements, and we have successfully gotten hundreds of banks off the troubled bank list and back to a state of reasonable health. But that is not enough. While we have worked to increase market discipline to help provide the incentive for sound management, the high level of deposit insurance and the high percentage of failures handled as mergers make effective depositor discipline hard to attain. Even higher capital standards, which would include subordinated debt, could result in imposition of the necessary discipline by suppliers of capital.

However, there is only so much we can do administratively. We have submitted to you our Federal Deposit Insurance Improvements Act. It would provide us with new tools such as the authority to implement risk-related insurance premiums, which would be far more equitable than the present system and would provide an incentive to sounder management. Our bill would also authorize us to charge troubled banks for the extra supervisory effort they require and would enable us to move promptly against officers engaging in abusive practices. Our bill also deals with the letter of credit problem alluded to earlier, and it would make permanent the emergency interstate takeover provisions of the Garn-St Germain Act that are scheduled to sunset this year. Events of the past year clearly call for priority attention to this legislation.

One problem we have tried to cope with so far, with little success, is brokered deposits. Our attempts to deal with this by regulation were struck down in the courts. Though we are still pursuing the case, the problem could easily be addressed through legislation. With today's technology, a banker so inclined can gather millions in brokered deposits so rapidly it defies regulatory detection until after the problem has become severe. The weakest banks are the worst abusers of this market and their failures have cost us hundreds of millions of dollars. Our potential liability runs to the billions, as we had over \$9 billion of brokered deposits in troubled banks at last report. There is no problem more threatening to the deposit insurance fund.

E. Conclusion. Mr. Chairman, I have now served over seven years with the FDIC, nearly four as Chairman. This will probably be my last appearance before you in that capacity. I have come to appreciate a number of things in that time.

I appreciate the importance of deposit insurance and the FDIC's role in helping to maintain stability in both our domestic and international financial markets. The handling of Continental Illinois Bank represented an effort to avoid what would almost certainly have been an international financial crisis. Not a single tax dollar was involved in that effort. But I also appreciate the need for substantial changes and improvements in a system created 51 years ago to deal with an entirely different set of problems and environment.

I appreciate the innovativeness of our American financial services industry. Most Americans welcome the opportunity to avail themselves of the new services that have been developed. But I am also aware of the fact that a minority opposed to change -- or increased competition -- can seemingly paralyze the Congress.

Mr. Chairman, I have heard you say more than once that the banking issues before the Committee today have been before it since you first came to the Senate. Indeed, many of them have, and we applaud your tireless efforts to resolve them. Last year's bill was a good beginning, and the vote on that bill showed that most members of this body are eager to see an end to the unproductive interindustry bickering which has stymied resolution of these issues for so many years. We understand the political pressures that have made progress so difficult, but would like to conclude with a plea for even broader action than you took last year.

The time is long past when we can view commercial banking in a vacuum. Those who would argue that commercial banking is unique because deposits are insured deliberately overlook the fact that thrifts, credit unions, and, increasingly, even investment banking firms offer federally insured deposits accessible by check or other transfer mechanisms. Thrifts have more liberal authorities, both regarding investments and geographic expansion, than do commercial banks or their holding companies, while both stock and mutual associations are exempted from prudential standards applied to commercial banks. Because the time has passed when these institutions are constrained by law to serve only a limited credit market,

or clientele, and because so many thrifts are wisely turning to stock ownership as a means of raising capital, we believe the time has come to phase in higher standards of capitalization, accounting and disclosure. We urge you to address these issues in any legislation you consider this year.

This Committee also has a unique opportunity -- I might even say responsibility -- to consider how the public can best be served by the broader spectrum of commercial and investment banking services. Your jurisdiction, unlike that of the House Banking Committee, covers both. You can address the disparities in geographic boundaries and product offerings between these two sectors of our financial services industry and reconcile them in the public interest. We feel very strongly that if our commercial banking industry is to remain a vigorous competitor serving the public, it must be accorded as much freedom as its major rivals. We hope you will address this in legislation this year.

Last, but certainly not least, we urge your attention this year to deposit insurance and regulatory reform. There should be no misunderstanding. Our urging expanded opportunities for commercial banks to offer new services in broader geographic areas -- termed "deregulation" -- does not imply less supervision of these activities. We firmly believe we must upgrade the quality of supervision and enforcement and find new ways to obtain greater discipline from the marketplace. We stand ready to work with you to develop 20th Century solutions to the problems of safety and soundness. We believe our Federal Deposit Insurance Improvements Act, S. 760, represents a good starting point for your consideration. Its major provisions, such as risk-related deposit insurance premiums, have been endorsed by the American Bankers Association, the Bush Task Group and a working group of the Cabinet Council on Economic Affairs. The time for action is now.

Thank you. I will be pleased to respond to any questions.

The CHAIRMAN. Thank you very much, Mr. Chairman.

First, let me say that this is probably your last appearance before this committee, at least in your present capacity. I'd certainly like to say that it's been a pleasure to work with you. We've worked together on some difficult problems the last few years, when the banking system was not an easy one to work with. You have probably been chairman of the FDIC at one of the most difficult times in the history of that organization, and particularly with the number of mergers and problem institutions you have had.

I personally would like to express my thanks to you for what I believe has been a very good job under some very difficult circumstances.

Mr. ISAAC. I thank you, Mr. Chairman, and I would like to reciprocate by thanking you for the support that you have given to us as we have tried to deal with those issues. You have been very supportive, and a number of the things we've done, we couldn't have done without your help. So I thank you.

The CHAIRMAN. Let me start with you where I ended with Chairman Volcker and ask you if the FDIC could supply us with some bank failure analysis from your perspective.

I think that might be very helpful along the line that Senator Riegle was pursuing, so we can make a more objective analysis of what deregulation has or has not done and try to look at it specifically and objectively rather than the emotion of, "Good heavens, those stupid banks can't handle what they're doing now. Why should we give them more powers?"

Mr. ISAAC. Do you mean a review of individual failures and why they occurred? The causes of the failure, and so forth?

I'd be happy to.

[The following information was subsequently submitted for the record:]



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

JUN 24 11 3 57

June 21, 1985

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

During my testimony on "Legislative Responses to Changes in Financial Services" on May 8 to your Committee, several items of additional information were requested. This letter will respond to those items which were not addressed by my previous correspondence.

1. An analysis of recent bank failures was desired with the intent of determining whether new banking powers were an important factor contributing to failure.

During the period of October 19, 1984 through February 8, 1985, 25 banks failed. In all but one instance, loan losses arising from management deficiencies within the bank constituted the major cause of failure. Even in the one exception, however, there existed notable credit problems. Adverse economic conditions, especially related to the agricultural and energy sectors of the economy, contributed to failure in 18 cases but in no instance constituted the major cause. Agricultural conditions compounded problems leading to 11 failures while oil and gas industry conditions impacted situations in five failures. A poor local tourist-oriented economy was a factor in one failure, and deflation in the real estate sector in another.

Within the category of loan losses, as defined above, are several principal causal activities including insider abuse, liberal and imprudent lending practices, poor loan administration and servicing, and lax supervision of the lending function by the board and/or the chief executive officer. Fraud and reliance on brokered and other interest-sensitive funds were major contributors to a number of the failures.

In only two instances did failure stem from single causes, both somewhat unique. All of the other failures were primarily caused by combinations of activities (i.e., insider abuse, liberal lending and fraud). The following

sets forth the activities primarily responsible for failure of the 25 banks analyzed:

<u>Activity</u>	<u>No. of Instances Present</u>
Liberal and imprudent lending policies and/or practices	19
Lax supervision by board of directors and/or the chief executive officer	10
Insider abuse	8
Poor loan administration and servicing	8
Fraud or forgery	5
Reliance on volatile interest-sensitive funds	3
Establishment and mismanagement of insurance premium financing department	1
Merger with an S&L resulting in severe asset-liability rate mismatch and large volume of other real estate	1

In only one situation out of the 25 analyzed did the entry into a new business -- insurance premium financing -- lead to failure. However, it should be noted that this activity involved the traditional function of bank lending, though it involved a new type of lending for the bank, and losses were caused by imprudent credit and fraudulent practices.

2. A prospective analysis of adverse trends in business sectors which may indicate significant loan problems for banks in the future was requested.

Several sectors have weakened in recent years with resulting problems for banks which had a significant lending involvement. Well-known examples are real estate, agriculture and energy. Mining, heavy manufacturing and high technology have also experienced difficulties. Banks operating in areas dominated by these businesses may suffer if conditions worsen. Many larger banks have significant exposure through debt to lesser developed countries. While some improvements have recently occurred in this area, the possibility of serious problems in the future cannot be ruled out. The thrift industry has experienced well-publicized problems in recent years due to the unpredictable interest rate climate and, increasingly, to credit quality problems. These are known areas of potential difficulty. Obviously, problem areas may improve and areas not presently identified may become a source of problems.

A bank is to a large degree a captive of its market. If the local economy is heavily dependent on one company or one economic sector, the banks cannot avoid the impact of that company's or industry's adversity. Even so, prudent management should prevent banking failures. While the impact may be severe for individual banks, the banking system as a whole is diversified enough that serious systemwide problems due to adversity in any single sector of the economy is not expected. This diversity is important in that it is not always possible to anticipate in advance what segment of the economy may be the next one with serious difficulties.

3. Information was requested on banks which have applied for FSLIC insurance. The possibility of attempting to move to less restrictive regulation was raised.

Nineteen applications for conversion to FSLIC insurance for 1983, 1984 and to date in 1985 have been reviewed. Approximately 80 percent of these applications cited regulatory concerns as reasons for the request. These concerns generally involved expanded powers, lower capital requirements, more liberal accounting rules and more favorable expansion (branching/acquisitions) rules.

4. Specific recommendations of the FDIC to amend the antitrust laws were invited.

As the artificial barriers to product and geographic expansion by financial institutions are dismantled by legislation and the marketplace, antitrust laws should be changed and enforcement strengthened to promote a healthy competitive environment. For example, we believe it would be clearly a benefit to competition for one of the nation's larger banking organizations to enter a major new product or geographic market on a *de novo* basis or via a foothold acquisition. Conversely, the competitive benefit would be questionable if such an organization were to enter by acquiring a large established competitor in that market. Current antitrust laws, however, largely ignore the long-range structural or concentration implications of an acquisition and would not likely prohibit sizable combinations. It would seem reasonable for antitrust laws to prohibit business combinations that have adverse competitive implications of both a short- and long-range nature.

The FDIC's concern in this regard is not only from the viewpoint of competition, but also from the perspective of the safety of the insurance fund. As with any insurer, we want our risk diversified as much as is both possible and reasonable. We support amending antitrust laws to prohibit the largest institutions in the country, as well as in individual states or regions, from merging (except in an emergency) as a step to guard against undue business concentrations. We will be pleased to provide draft statutory language should you desire.

Regarding antitrust regulatory responsibility, the FDIC has often expressed the need to eliminate unnecessary regulatory duplication between federal financial institution regulators and the Justice Department regarding competitive aspects of financial institution mergers. We generally concur with the thrust of the

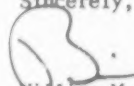
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report of the Task Group on Regulation of Financial Services which recommends that the Antitrust Division of the Justice Department be given the exclusive authority to review the competitive aspects of nonemergency and nonsupervisory depository institution mergers and be responsible for implementing policy in this regard.

5. A list of failed banks and their uniform rating was requested.

Attached is a list of banks which failed in 1984 and through June 11, 1985, and their composite CAMEL ratings as of the date of failure.

Sincerely,



William M. Isaac
Chairman

Attachment

1985

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>\$ ASSETS</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
1. Citizens State Bank Edgerton, WY	1-4-85 2,831	5
2. State Bank of Dannebrog Dannebrog, NE	1-7-85 4,318	5
3. Coast Community Bank Harbor OR	1-11-85 9,054	5
4. The First National Bank in Marlow Marlow, OK	1-24-85 27,451	5
5. First National Bank in Clarksville Clarksville, TX	1-24-85 29,248	5
6. The Steele State Bank Cherokee, IA	1-25-85 19,277	5
7. Citizens Fidelity Bank Bristol, TN	2-1-85 16,360	5
8. First National Bank Bank of Woodbine Woodbine, IA	2-7-85 26,774	5
9. Farmers National Bank of Erick Erick, OK	2-7-85 17,659	5
10. Peoples Bank and Trust Company Wartburg, TN	2-8-85 23,122	5
11. West Valley Bank Woodland Hills, CA	2-8-85 41,169	5
12. First National Bank of Eads Eads, CO	2-14-85 16,906	5

1985

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>\$ ASSETS</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
13. Citizens State Bank of Fulda Fulda, MN	2-15-85 38,095	5
14. Inwood State Bank Inwood, IA	2-19-85 7,094	5
15. Halifax National Bank of Port Orange Port Orange, FL	3-1-85 38,234	5
16. Citizens State Bank Arapahoe, NE	3-8-85 15,675	5
17. Commercial State Bank Afton, IA	3-8-85 15,988	5
18. Taylor State Bank Emington, IL	3-15-85 4,789	5
19. Golden Valley Bank Turlock, CA	3-22-85 72,291	5
20. Fidelity Bank of Denver Denver, CO	3-29-85 43,979	5
21. The Bank of Hunter Hunter, OK	4-4-85 2,860	5
22. Capistrano National Bank San Juan Capistrano, CA	4-5-85 51,102	5
23. State Bank of Alexandria Alexandria, NE	4-11-85 2,559	5
24. First State Bank of Elgin Elgin, OR	4-12-85 17,778	5

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1985

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>\$ ASSETS</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
25. South Coast Bank Costa Mesa, CA	4-12-85 31,737	5
26. Peoples National Bank of Lampasas Lampasas, TX	4-18-85 33,854	5
27. The First National Bank of Springfield Springfield, CO	4-18-85 15,274	4
28. Peoples State Bank Odebolt, IA	4-26-85 13,294	5
29. First Enterprise Bank Oakland, CA	4-26-85 40,803	5
30. The Bank of Commerce Chanute, KS	5-2-85 67,131	5
31. Farmers Savings, Bank Massena, IA	5-3-85 66,102	5
32. Farmers State Bank, St. Joseph St. Joseph, MO	5-3-85 49,585	5
33. Story County State Bank Story City, IA	5-9-85 32,654	5
34. Bank of Newcastle Newcastle, OK	5-16-85 31,118	5
35. The Energy Bank, National Association Dallas, TX	5-16-85 30,693	5
36. Northwest Bank White Settlement, TX	5-23-85 51,906	5

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1985

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>\$ ASSETS</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
37. Bank of Taylor Taylor, NE	5-31-85 13,829	5
38. Bank of Lockesburg Lockesburg, AR	5-31-85 27,171	5
39. The Bank of Oregon Woodburn, OR	5-31-85 108,756	5
40. First Trust Bank of Lakefield Lakefield, MN	5-31-85 23,849	5
41. Fairfield State Bank Fairfield, NE	6-2-85 6,184	5
42. Scroggin and Company Bank Oak, NE	6-2-85 3,219	5
43. Security State Bank Edgar, NE	6-2-85 5,785	5
44. American National Bank of Riverton Riverton, WY	6-11-85 36,827	5

1984

NAME/LOCATION	DATE CLOSED	COMPOSITE CAMEL RATING AT CLOSING
	ASSETS \$	
1. Farmers Bank & Trust Company Winchester, TN	1-6-84 48,614	5
2. City & County Bank of Jefferson County White Pine, TN	1-20-84 22,238	5
3. Indian Springs State Bank Kansas City, KS	1-27-84 27,942	5
4. Emerald Empire Banking Company Springfield, OR	2-3-84 20,529	5
5. Tucker County Bank Parsons, WV	2-3-84 16,447	5
6. Heritage Bank of Bureau County Depue, IL	2-8-84 8,661	5
7. West Olympia Bank Los Angeles, CA	2-10-84 18,898	5
8. Brownfield State Bank and Trust Company Brownfield, TX	2-17-84 38,201	5
9. United Bank of Oregon Milwaukie, OR	3-2-84 16,192	5
10. All American National Bank Virginia Gardens, FL	3-2-84 13,313	5
11. National Bank & Trust Company of Traverse City Traverse City, MI	3-9-84 78,677	5

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1984

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>ASSETS \$</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
12. Heritage Bank Anaheim, CA	3-16-84 157,840	5
13. Seminole State National Seminole, TX	3-16-84 47,996	5
14. Wautaga Valley Bank Elizabethton, TN	4-6-84 13,389	4
15. First Security Bank Erwin, TN	4-6-84 23,800	5
16. Security National Bank of Lubbock Lubbock, TX	4-13-84 48,200	5
17. Gamaliel Bank Gamaliel, KY	4-19-84 22,564	5
18. The Shelby National Bank of Shelbyville Shelbyville, IN	4-19-84 64,226	5
19. United of America Bank Chicago, IL	4-26-84 34,232	5
20. West Coast Bank Los Angeles, CA	4-27-84 185,593	5
21. Citizens Bank of Monroe County Tellico Plains, TN	4-27-84 20,525	5
22. First National Bank of Snyder, TX Snyder, TX	5-4-84 20,475	5

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1984

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>ASSETS \$</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
23. The First National Bank of Rushford Rushford, MN	5-4-84 21,608	5
24. Western National Bank of Casper Casper, WY	5-4-84 24,266	5
25. State Bank of Mills Mills, WY	5-4-84 6,845	5
26. The National Bank of Carmel Carmel-By-The-Sea, CA	5-8-84 96,828	5
27. The Mississippi Bank Jackson, MI	5-11-84 241,270	5
28. First Continental Bank & Trust Company of Del City Del City, OK	5-11-84 110,471	5
29. Bank of Irvine Irvine, CA	5-18-84 30,661	5
30. Planters Trust & Savings Bank of Opelousas Opelousas, LA	5-18-84 67,183	5
31. Bledsoe County Bank Pikeville, TN	5-18-84 5,128	5
32. Washington National Bank of Chicago Chicago, IL	5-18-84 15,020	5
33. First National Bank of Prior Lake Prior Lake, MN	5-24-84 14,283	5
34. Garden Grove Community Bank Garden Grove, CA	6-1-84 39,485	5

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1984

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>ASSETS \$</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
35. Cherokee County Bank Centre, AL	6-5-84 38,780	5
36. Stewardship Bank Portland, OR	6-8-84 5,823	5
37. The Corning Bank Corning, AR	6-15-84 35,519	5
38. Farmers State Bank Lyons, SD	6-15-84 3,227	5
39. The Lawrence County Bank Lawrenceburg, TN	6-15-84 24,344	5
40. Republic Bank of Kansas City Kansas City, MO	6-18-84 42,268	5
41. The Farmers National Bank of Aurelia Aurelia, IA	6-20-84 19,413	5
42. American Bank St. Joseph, TN	6-27-84 35,399	5
43. East Texas Bank & Trust Company Longview, TX	6-29-84 99,746	5
44. Coffeen National Bank Coffeen, IL	7-12-84 9,601	5
45. Guaranty Bank of St. Paul St. Paul, MN	7-20-84 27,477	5
46. Coalmont Savings Bank Coalmont, TN	7-24-84 25,218	5

1984

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>ASSETS \$</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
47. Jackson County National Bank Tuckerman, AK	8-9-84 14,000	5
48. Peoples State Bank of Clay County Poland, IN	8-10-84 13,057	5
49. The Tingley State Savings Bank Mt. Ayr, IA	8-10-84 18,843	5
50. American National Bank McLean, TX	8-16-84 14,420	5
51. Girod Trust Company San Juan, PR	8-16-84 412,018	5
52. The First State Bank Thayer, KS	8-22-84 12,396	5
53. Hereford State Bank Hereford, CO	8-24-84 2,690	5
54. Bank of the Northwest Eugene, OR	8-31-84 21,028	5
55. David City Bank David City, NE	9-6-84 21,398	5
56. Oakland Savings Bank Oakland, IA	9-7-84 21,647	5
57. Community Bank & Trust Company Enid, OK	9-14-84 30,966	5
58. Bank of Verdigre and Trust Company Verdigre, NE	9-19-84 13,226	5

1984

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>ASSETS \$</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
59. Century National Bank Jacksonville, FL	9-20-84 15,245	5
60. Security State Bank Weatherford, OK	9-21-84 54,675	5
61. The Farmers and Merchants Bank Tecumseh, OK	10-5-84 29,507	5
62. Orange Savings Bank Livingston, NJ	9-28-84 513,376	5
63. The Rexford State Bank Rexford, KS	10-10-84 5,807	5
64. Oneida Bank & Trust Company Oneida, TN	10-12-84 5,712	5
65. Bucklin State Bank of Bucklin, Missouri Bucklin, MO	10-12-84 14,388	5
66. American State Bank Thomas, OK	10-19-84 22,888	5
67. Farmers State Bank Kilgore, NE	10-24-84 6,005	5
68. Bank of Cody Cody, NE	10-24-84 10,900	5
69. State Bank of Boyd Boyd, MN	10-24-84 6,889	5

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1984

<u>NAME/LOCATION</u>	<u>DATE CLOSED</u> <u>ASSETS \$</u>	<u>COMPOSITE CAMEL</u> <u>RATING AT CLOSING</u>
70. The First National Bank of Gaylord Gaylord, KS	10-25-84 6,590	5
71. First American Banking Company Pendleton, OR	11-16-84 18,168	5
72. The Strong City State Bank Strong City, KS	11-29-84 4,584	5
73. The Dayton Bank & Trust Company Dayton, TN	11-30-84 49,109	5
74. Golden Spike State Bank Tremonton, UT	12-4-84 7,303	5
75. Farmers State Bank of Holyoke Holyoke, CO	12-7-84 4,121	5
76. University Bank of Wichita Wichita, KS	12-11-84 5,111	5
77. Uehling State Bank Uehling, NE	12-18-84 4,259	5
78. Farmers State Bank Selden, KS	12-20-84 14,642	5
79. First Security Bank Sandwich, IL	12-22-84 11,049	5

Senator RIEGLE. Mr. Chairman, would you yield at that point?

The CHAIRMAN. Certainly.

Senator RIEGLE. I appreciate very much your support of attempting to try to throw a little more light on this.

I'm actually interested in something in addition to that. In other words, it's one thing to go back and do the autopsy on the failures. And I think there's some value in that, and I hope that can be done.

But I'm actually more concerned about the trend lines and where they seem to be taking us. I'm more concerned about looking at a continuum that might say to us the period ahead would seem to suggest that we may be headed into difficulty. The number of problem banks are certainly going up.

In that context, it's sort of a requirement to take a look at the foreign loan problem, which is one sort of dark cloud that hangs over a certain number of banks.

You've also got the agricultural loan problem, which is a new kind of sectoral problem. I think there's a real estate problem building up in commercial real estate that's going to impact certain banks more than others, which I think may also be like a mist on the horizon now but be in the process of enlarging into a bigger dark cloud.

And also industrial-base derived problems that spinoff the trade deficit, which is still worsening.

So I have this concern that I want to be able to address and allay, if it can be allayed. It says that maybe these trend lines are about to take us into even greater difficulty because of some new problems that are coming at us.

So I don't want to just look backward in a diagnostic sense, I want to try to figure out what the dynamics are that are at play which we ought to take into account.

And I'm not trying to stack the deck, I just want to understand what reality looks like through the window of different people, like Volcker, yourself and, obviously, we may have different opinions around this table. But that's really what I'm driving at, Mr. Chairman.

POSTMORTEM DONE ON EVERY FAILED BANK

Mr. ISAAC. We have both types of information readily available. We do, as a matter of course, a postmortem on every failed bank, and so we have that information readily available.

We also, at least a couple of times a year, try to do projections out into the future.

Senator RIEGLE. Well, if you could share both of those with us, I would find it very helpful to me.

Mr. ISAAC. Sure.

The CHAIRMAN. Mr. Chairman, you suggest a broader bill than S. 2851. What other products and services would you permit if you were writing the bill?

Mr. ISAAC. Well, if I were writing the bill and didn't have to be concerned about your political problems, I would be—

The CHAIRMAN. That's the nature of the question.

Mr. ISAAC. I would be much broader.

The CHAIRMAN. I'm not asking you to count votes, just your opinion.

Mr. ISAAC. In my opinion, we should repeal the Glass-Steagall Act. We should repeal the Bank Holding Company Act. And we should repeal McFadden-Douglas.

The CHAIRMAN. Well, that certainly takes care of all the—
[Laughter.]

Mr. ISAAC. But you asked me to.

The CHAIRMAN. Now, assuming that we did [laughter] all of that, then what safeguards would you put back? Where would you start rebuilding the infrastructure?

Mr. ISAAC. I would strengthen the antitrust laws considerably. You see, the Bank Holding Act, there's a misperception about it. A lot of people have this notion that the Bank Holding Company Act was conceived out of some desire to strengthen safety and soundness in the banking system. And that wasn't the purpose of it at all.

The purpose of the Bank Holding Company Act when it was adopted in 1956, at the urging of Marriner Eccles, who was then Chairman of the Federal Reserve, was to deal with the growing concentration of economic resources represented most vividly by the Transamerica empire being assembled in the Western States by A.P. Gianini.

The Bank Holding Company Act is not a law that was intended to separate banking from commerce. Banking is not separated from commerce today. S&L's are owned by commercial firms. Two years ago, in the Garn-St Germain Act, the Congress directed us to insure industrial banks, which are owned by commercial firms and bank holding companies throughout the Nation. Since 1969, the FDIC has been allowing insurance for nonbank banks.

And throughout the Nation, there are thousands of banks that are owned by automobile dealers, insurance companies, real estate agents, and the like. The only thing they're prohibited from doing is putting them under a common corporate umbrella.

Not one FDIC-insured nonbank bank and not one FDIC-insured industrial bank has ever been placed on our problem bank list, much less failed. The issue is not a safety and soundness issue. We can protect safety and soundness. We want only good people in banking, and we have the means to accomplish that through the Change of Bank Control Act, which was adopted just a few years ago by the Congress.

We can keep for the most part—we may slip up every now and again—but we can keep undesirable people out of banking. And when we find them in banking, we can get them out. We don't need a Bank Holding Company Act to protect against abusive practices.

The Bank Holding Company Act was designed to prevent an undue concentration of economic resources. And the most effective way to do that is to have a much stronger antitrust law, and have it enforced, one that does not allow the major aggregations to occur, one that prohibits significant acquisitions by major firms.

That's a much more effective way. I think we'd wind up with a much stronger banking system, one that would be much more re-

sponsive to the needs of the American public, and more competitive.

The CHAIRMAN. Well, I appreciate your candor and I've always thought I had a lot of courage, but I haven't got the courage to try to repeal all of those. I mean, compared to my answer to Chairman Volcker about a trigger in interstate banking, I don't think we'd find four votes for your proposal.

But I appreciate your comments very much.

You suggest, and this is not new, any institution which calls itself a bank be insured by the FDIC and be subject to the Bank Holding Company Act. You recommended that last year.

What advantages do you feel that definition has over the definition of a bank in S. 2851?

Mr. ISAAC. Well, let me, if I could, add one final thought on the previous question. That is, I prefaced my answer by saying: Do you want me to answer without regard to a political context? I operate under no illusion whatsoever that you're going to repeal Glass-Steagall or that you're going to repeal the Bank Holding Company Act.

I do think that it's important that we understand why there is a Bank Holding Company Act—because it helps us put the deregulation debate in the proper perspective. And I see no reason why we shouldn't open up the financial service fields pretty broadly and allow much more competition in those markets.

FDIC'S DEFINITION OF A BANK

The definition of a bank preferred by the FDIC is that any institution that calls itself a bank and takes deposits from the public should be insured by the FDIC and subject to bank-type regulation, including the provisions of the Bank Holding Company Act if it's owned by a bank holding company.

We believe that definition would serve several purposes. No. 1, it would prevent continuing abuses and tragedies like we've seen in Ohio, Tennessee, Iowa, Nebraska, and elsewhere, where institutions have held themselves out to the public as being banks, safe places to put your life savings, and then they have failed and the public has discovered they're either not insured at all or they are insured by a private fund that doesn't have the resources to deal with the failure. Our proposal would pretty much eliminate that problem.

Our proposal would also close the nonbank bank loophole.

And, finally, it would deter the practice of S&L's and other thrift institutions calling themselves banks, holding themselves out to the public as banks, but yet not being subject to the same type of supervision and prudential standards—and, namely, I'm referring to capital, accounting, and disclosure rules that banks are subject to.

We have banks coming to us—we had something like 15 in the past year—and asking to switch to FSLIC insurance and Bank Board regulation, because they want to escape our accounting, disclosure and capital rules.

And I know Mr. Proxmire's been concerned for years with competition in laxity and it's coming in spades right now in this area.

Just a couple of weeks ago, we approved an application, because we had no way to prohibit it, by a \$1 billion bank to convert to FSLIC insurance—for the express purpose of leveraging further, as S&L's are permitted to do.

The CHAIRMAN. Well, I assume then you certainly would feel that all savings banks be required to have FDIC insurance?

Mr. ISAAC. Any institution that calls itself a bank should have FDIC insurance.

The CHAIRMAN. Well, but I'm going further. Not necessarily, say, savings bank but that nebulous category in between S&L's and banks, you would want FDIC insurance on them as well?

Mr. ISAAC. Yes.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Speaking of competition in laxity, Mr. Isaac, have there been other recent examples of banks converting to thrift charter to take advantage of the lower capital requirements and looser accounting standards permitted by the Home Loan Bank Board?

Mr. ISAAC. Yes; 15 times or so in the past year and as recently as 2 weeks ago, a \$1 billion bank did.

Senator PROXMIRE. Would you file that for the record to give us the details?

Mr. ISAAC. Yes, be happy to.

[Information may be found on p. 177.]

Senator PROXMIRE. Several years ago, this committee discovered that in many FDIC-supervised banks, the officers of the bank were also credit life insurance agents and were personally benefiting from the loans they made by tying the loan to credit life insurance.

As you know, officers of national banks are prohibited from pocketing credit life insurance premiums.

The question is, what have you done during your tenure to end this scam by State banks?

Mr. ISAAC. We have rules that require disclosure of the credit life practices to the shareholders and approval by them, and the board of directors.

I would like to go much further and just ban it entirely. The Federal Reserve has not been willing to go that far. They still allow, for example—

Senator PROXMIRE. Well, the Comptroller has. Why can't you?

Mr. ISAAC. The Comptroller doesn't. It still allows a bank holding company to take the—

Senator PROXMIRE. Yes, but officers of a bank are prohibited, aren't they?

Mr. ISAAC. Pardon?

Senator PROXMIRE. The Comptroller prohibits a bank officer from acting as an agent.

Mr. ISAAC. The Comptroller prohibits an individual from receiving the credit life insurance premiums. But, the problem is—

Senator PROXMIRE. Why can't the FDIC do the same thing?

Mr. ISAAC. It doesn't accomplish anything because I can form a one-bank holding company to take over ownership of the bank and divert the credit life premiums to my one bank holding company just as easily. The only thing I can't do is I can't do it as an indi-

vidual. I can form a corporate shell, a one-bank holding company, and divert the credit life for that purpose.

I wanted to shut down that practice, the Federal Reserve didn't, and so I didn't go along with the proposal. I would be more than happy to shut it all down any time anybody wants to. I think the practice of diverting credit life insurance premiums is deplorable and should be stopped.

Senator PROXMIRE. You feel that if you did what the Comptroller's done, it wouldn't be——

Mr. ISAAC. All the people would do is go out and form a bunch of one-bank holding companies and divert the——

Senator PROXMIRE. Have they done that? Have the national banks done that?

Mr. ISAAC. Yes.

Senator PROXMIRE. Consistently?

Mr. ISAAC. Yes.

Senator PROXMIRE. Thank you. Can you document that for the record for me?

Mr. ISAAC. Sure. Be happy to.

Senator PROXMIRE. Good.

[The following information was subsequently submitted for the record:]



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

1985 MAY 20 AM 2:41

May 16, 1985

Honorable William Proxmire
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Bill:

During the May 8, 1985 hearing before the Senate Committee on Banking, Housing and Urban Affairs you questioned me on the FDIC's policy regarding the disposition of credit life insurance premiums. You requested documented cases where banks have formed one bank holding companies for the purpose of circumventing restrictions against the retention of insurance premiums by bank officers. Upon reflection, I realize that this cannot be authoritatively documented because there is seldom only one motivation for forming a one bank holding company and I doubt that very many applicants would be so bold as to state explicitly this particular motivation.

However, on the basis of many years of experience on both sides of the regulatory fence, I know this practice has occurred with considerable frequency. Indeed, one of the principal reasons the Federal Reserve gave in 1981 for not wanting to prohibit credit life income distribution to bank holding companies was that many companies were relying on this income to service their debts.

My objections to the rules proposed in 1981 by FFIEC should not be construed as condoning the practice of allocating credit life premium income to individual officers or directors. I strongly object to the notion that any income derived from any bank operations should be diverted to officers, directors or selected stockholders of a bank. My objection to the FFIEC proposal was that it permitted the continuation of this practice by the simple expedient of upstreaming the premium income to a holding company. I was prepared in 1981 and remain prepared today to support a complete ban on the diversion of any credit life income, if the other two federal agencies will join in such a ban. I understand the Federal Reserve's concern about existing bank holding companies that are relying on credit life as a source of income to service acquisition debts and would be willing to allow (as I was in 1981) a phase-in for these companies.

I trust this is responsive to your inquiry and appreciate your concerns about these practices.

Sincerely,

William M. Isaac
Chairman

RECORD NUMBER OF BANK FAILURES

Senator PROXMIRE. Now last year we had a record number of bank failures, 79, the greatest number since the early 1930's. There are also substantially more banks on the problem list, as you know. Some will argue that these developments should bring a stop to any further attempts to deregulate the bank industry.

Now how do you respond to that argument that now is not the time for more deregulation?

Mr. ISAAC. The response I would give is that the problems in the banking industry have virtually nothing to do with deregulation. The problems in the banking industry are due primarily to the mismanagement of fiscal policy by the Federal Government. We have had more than 10 years of accelerating inflation, which caused serious distortions in investment and credit decisions, people counting on inflation continuing, followed by very high and volatile interest rates, two back-to-back recessions, the second the most severe in 50 years, and then disinflation or deflation in sectors such as energy and agriculture. The problems we are experiencing in the banking industry are due almost exclusively to that.

The institutions that are feeling it the most are the more marginal institutions, the ones that gambled excessively on continuing inflation. If I could identify the No. 1 threat to financial stability today, it is without question, the Federal budget deficit. If we could get that down, get interest rates down, get the dollar headed down, there is almost no problem facing banks today that would not be substantially alleviated.

The second most serious problem is the lack of comprehensive banking legislation. We need to look at the deposit insurance system and straighten it out, bring it up to date. We need to broaden the powers of banks.

Senator PROXMIRE. That is an excellent answer, and I agree with all of it. I would add that more vigorous examination by the regulators is needed.

Mr. ISAAC. I am sorry. I agree completely on that. We definitely need to strengthen supervision, and I think we are doing some things in that area. I would not take issue for 1 minute.

Senator PROXMIRE. You feel very strongly that further deregulation of the banking industry along the lines that you suggest should go much farther, of course, than the bill we passed last year, would not have any adverse effect on safety and soundness?

Mr. ISAAC. It would have a very positive effect.

Senator PROXMIRE. Positive?

Mr. ISAAC. Yes.

Senator PROXMIRE. Now on page 2 of your statement, you say that the FDIC is not opposed to extending the Net Worth Certificate Program, provided thrifts are mandated to conform over time with the capital standards and accounting rules adopted by the banks.

What in your view would be a reasonable period of time for the thrifts to reach capital adequacy?

Mr. ISAAC. I could live with almost any period of time. It is not important how long. The thrifts have a serious problem, and we

need to give them time to come into compliance with reasonable accounting and capital standards.

It is not so important how long the time period is. It is only important that we adopt a time period and we direct them to start coming into conformity. You can't do it in less than 5 years. I think you need at least that.

Senator PROXMIRE. Well, the Bush Commission recommended 7 years.

Mr. ISAAC. You need at least 5. I could live with 10 or anything in between.

Senator PROXMIRE. I beg your pardon.

Mr. ISAAC. You need at least 5 years. I could live with 10 or anything in between.

Senator PROXMIRE. Could your agency draft legislation for this committee to enact that kind of a mandate?

Mr. ISAAC. We would be pleased to.

BROKERED DEPOSITS

Senator PROXMIRE. Last year S. 2851 placed certain restrictions on brokered deposits; however, deposits of more than 1 year were excluded and the authority of the regulator to impose stiffer limits was called into question. On balance, do you regard last year's section on broker deposits as better than nothing, or would the FDIC be better off if the entire provision was dropped and you took your chances with the courts?

Mr. ISAAC. We would be better off with no provision on brokered deposits than the one that was enacted last year. It has two very serious flaws. One was, it exempted long-term brokered funds from any coverage, which means that we will simply have a problem of long-term brokered funds instead of a problem with short-term brokered funds. Long-term brokered funds are more expensive funds and, therefore, can actually cause more damage.

The other problem we had with the bill is that it seemed to imply, at least, that if a bank met a 3-percent net worth test, it could have brokered funds up to the limit on short term and no limit on long term. And there was nothing we could do about it, even though it was a problem bank or troubled bank. It took away our existing enforcement authority. Right now we can go into a bank, even though it might have 4- or 5-percent capital, and if it is a troubled bank, we can say, you can't have any more brokered funds. We can put a cease and desist order in place saying that. And the bill seemed to take that authority away from us. We would be much better off not having a bill than to have that one.

Senator PROXMIRE. Given our restrictions on interstate banking, the top 10 banks control less than 30 percent of the banking business compared to 95 percent or more in most European countries and most every other country in the world.

Do you think our low concentration level is a desirable state of affairs, or do you think the country would be better off if we moved toward the European-Japanese model?

Mr. ISAAC. I am strongly opposed to any significant concentration of economic or financial power in this country and believe that our present concentration levels are desirable. Although some modest

increase wouldn't bother me, I like our system. I think you can accomplish it without artificial restraints, like McFadden-Douglas, through a much stronger antitrust law.

Senator PROXMIRE. Now you have said that several times, but, you know, you look around at American industry, we have three big automobile companies that completely dominate that industry. They have been under the antitrust laws for years.

How much of the banking industry would the top 10 control, if we removed all restrictions on interstate banking?

Mr. ISAAC. It depends. If we had no change in the antitrust law, I suspect there would be a tremendous amount of concentration occurring.

Senator PROXMIRE. Again, would you give us your specific recommendations for changes in the antitrust laws, because I believe as you do, that competition is the name of the game, and why this country has done so well. We should do everything we can to have stricter antitrust laws, but that, as you know, is very, very tough to achieve. And it is not just concerned with banking, we have to do that with all of American industry at the same time. It's good to talk about and it's good to work for. But it is not a very realistic prospect we can achieve it.

Mr. ISAAC. I agree essentially with the kind of proposals that Chairman Volcker has put forward, that the largest institutions ought to be banned from making acquisitions of any significant size, just a flat out ban.

Senator PROXMIRE. But don't you think Congress should have a good answer to the question on how much of the banking industry the top 10 would control, before we lift restrictions on interstate banks?

Mr. ISAAC. Yes.

Senator PROXMIRE. Thank you, Mr. Chairman. I have nothing further.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman.

Mr. Isaac, among all of the banking issues which face the committee, interstate banking, you know, powers, nonbank banks, deposit insurance, and the like, how would you rank them in order, and specifically, how high do you rank reform or a set of changes in deposit insurance regulation, in a sense of urgency or in the set of priorities we must impose on ourselves?

Mr. ISAAC. I believe all of them are very important and are inter-related. It is very hard to deal with one subject and not the others. With those caveats, I would rank them in order of importance, No. 1, deposit insurance reform, No. 2, broader powers, No. 3, geographic restraints.

Senator GORTON. So you would feel very unhappy, if you were to report a bill out of this committee that did not address deposit insurance?

Mr. ISAAC. Yes; I would.

Senator GORTON. On another subject, I have been informed that a majority of failed banks had CAMEL ratings of 1 or 2 on the call report immediately preceding their closure. If true, this obviously has profound implications for bank examiners to spot and deal with problems.

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Can you confirm or do you deny the allegation?

Mr. ISAAC. I will confirm that it is false. [Laughter.]

Senator GORTON. It is not the case?

Mr. ISAAC. That is not true.

Senator GORTON. Can you supply for the record what the camel ratings were for those banks under your jurisdiction which failed as of the call report immediately preceding their failure?

Mr. ISAAC. Sure. There are cases where you have 1 or 2 rated banks that fail. More often than not, what is involved there is fraud. You walk into the bank and you find a lot of fraud and an otherwise healthy looking bank is out of capital.

Senator GORTON. OK. I'd appreciate your supplying us with that information.

[See previous page 175.]

Senator GORTON. The recent Cabinet Council report on deposit insurance reform says that bank earnings continue to be weak. On the other hand, the most recent Salomon Bros. bank report says investors should look for another good year in bank stocks. [Laughter.]

What are the facts? How strong or weak are bank earnings in their historical context?

BANK EARNINGS ABOUT \$15 BILLION

Mr. ISAAC. I don't think bank earnings are weak. The banking industry earned about \$15 billion last year and \$15 billion the year before, making it the third most profitable industry in the country. There is more disparity in earnings now than you used to see. There are some banks that are doing very well, and there are some banks that are doing very poorly. Small banks have been under pressure on their earnings more so than larger banks in the last year or two, not because of deregulation, as some people have said, but because of loan losses, primarily.

But when you consider the competitive pressures that the banks are facing today and consider the economic environment in which they are operating, the condition of the vast bulk of banks is remarkably good.

Senator GORTON. The heart of our system for preserving confidence in that system are bank examinations and supervision. Are you satisfied with the size and quality of your bank examination staff? What needs to be done in your organization and here in the Congress, in order to improve that situation?

Mr. ISAAC. I'm pretty much satisfied with the size and the quality of our work force. We need more people in some regions. We have had some turnover and a growing number of problems. But the size of the work force is close to where we want it to be. The quality is good. One of the most satisfying parts of being at the FDIC in the past several years for me has been to work with this highly skilled and dedicated work force that will do almost anything you ask. They will walk through fire, if you want them to do that, to handle some banking problem in some remote place.

I am very satisfied with the quality of the people. We do need to focus their efforts better in certain areas. We need to be more alert to developing problems. We need to be looking at problem banks

more closely and paying less attention to banks that have a record of good performance and no abuses. We need to be much tougher about and swifter with our enforcement actions. That is happening.

To give you an example, in 1980, the FDIC took 50 formal enforcement actions. In the past 2 years, I think we have averaged something like 250 formal enforcement actions per year.

We are removing officers and directors more frequently. We are fining people more frequently. We recently levied a \$5.4 million fine against three officers of a bank, the largest civil money penalty I think I have ever heard of.

So I think we are toughening up. We do need to improve our training programs, and we are investing a lot of money in that effort right now. I am satisfied with where we are, with the progress we have made and where we are headed.

PUBLIC DISCLOSURE OF ENFORCEMENT PROCEEDINGS

Senator GORTON. One last question. You have created something of a storm with your new regulation on public disclosure of enforcement proceedings. I gather the principal criticism is that this undercuts confidence in the banking system in the United States on the part of the general public.

Would you give me at least a brief rationale for the action and your response to that criticism.

Mr. ISAAC. First of all, I think that much of the criticism we received has been alleviated now. I met with the California bankers this morning. They had been strongly concerned about or opposed to what we were proposing to do, and when they looked at what we finally did do, they told me this morning at breakfast that they were very supportive, highly in favor of it.

It's time to get people out of banking that aren't going to run their banks properly, and if public disclosure helps us do that, then I'd say we ought to have more of it.

I think the public can handle almost anything, as long as the public believes you are shooting straight, that you are telling them the truth. What they can't handle is uncertainty. They can't handle the belief that you are not telling them the truth about problems in banking. We have made every effort to tell the public the truth, and I think we have seen public confidence maintained at a very high level, despite a significant number of problems in the system in the past few years.

We believe disclosure is highly desirable, and we will continue to pursue it.

Senator GORTON. Mr. Isaac, that's all my questions. I don't want to let this opportunity go by without congratulating you on what I consider has been an extraordinary career and stewardship of the position that you have held, and thank you for your candor and your frankness and to wish you well in your future endeavors.

Mr. ISAAC. Thank you very much.

The CHAIRMAN. Senator Sasser, would you like to proceed until the next bell rings?

Senator SASSER. Thank you, Mr. Chairman, and I want to join with Senator Gorton in congratulating and commending Chairman

Isaac for his distinguished service at the FDIC. He's done, I think, an outstanding job under very, very, difficult circumstances.

Mr. Chairman, a recent article in the New York Times notes that there were 901 problem banks on the FDIC list as of mid-March, and I am also aware that there are a number of savings and loan institutions that will have to be merged during this year that will be drawing on the resources of the FSLIC fund.

Do you have any projections that you can give this committee as to the number of insured banks that may have to be liquidated or merged in 1985 and 1986?

Mr. ISAAC. Let me update the number on the problem banks for you. Today there are 949 banks on the problem list. Last year we handled 79 bank failures, primarily by merging them into other institutions. We expect to handle more than that this year.

Senator SASSER. Did you set a new record last year in bank failures?

Mr. ISAAC. That was a modern day or an FDIC record; yes. And we expect the number to be higher this year by some measure, not dramatically higher, but higher.

Senator SASSER. Right. Well, now are these banks most likely to fall in the realm of money center banks, agricultural banks? Do they fall in any particular classification?

Mr. ISAAC. The sectors where we are having the most problems right now are agriculture, energy, and to some degree, real estate. Those seem to be the areas of the economy that are giving us the most difficulty.

The banks have tended to be small, for the most part.

Senator SASSER. Can you give us some idea of the cause of these bank problems or bank failures and make a distinction between those bank failures or bank problems that are caused by economic problems?

The CHAIRMAN. Senator Sasser, could I interrupt you just for a moment—

Senator SASSER. Yes.

The CHAIRMAN [continuing]. We can proceed. I will leave and go over to vote, and if you and Senator Riegle would like to finish your questioning, I will tell them on the floor that you are coming, so you won't miss it. Then you would be able to finish your questioning, and I will go protect you.

Senator SASSER. Thank you very much.

The CHAIRMAN. And then when they're finished, we will stand in recess, and I will be back as quickly as I can for the next two witnesses.

Senator SASSER. What I am driving at, Mr. Chairman, is trying to determine the cause of the bank failures or make a distinction between those that are caused, the failures or problems that are caused by general economic conditions, and by that I mean the deflation that we are experiencing in certain agricultural areas of the country, the overvalued dollar which you referred to a moment ago and unforeseen economic trends, as opposed to those bank failures or bank problems that are associated with negligence, or incompetence, or even fraudulent management.

Could you give us some—perhaps some ballpark percentage figure as to how those would break down?

FRAUD AND INSIDER ABUSE ACCOUNT FOR 50 PERCENT OF FAILURES

Mr. ISAAC. Historically, approximately 50 percent of all bank failures have been caused by fraud and insider abuse. That held true again last year. It is hard to separate that, though, from economic conditions. Let's say that I own a bank, and I also happen to be, on the side, developing an apartment project. Because of economic conditions, my apartment project gets in difficulty. I am tempted to borrow some money from the bank to bail the project out, to tide me over until economic conditions improve, and then I'll, of course, repay the bank.

So problems in the economy tend to lead to more fraud and insider abuse. It is hard to separate those two. But 50 percent of all bank failures, historically, are caused by fraud and insider abuse. That is holding true today. The rest of the problems can be attributed to the economic conditions, coupled with bad management.

Senator SASSER. Well, it's now the policy of the FDIC, as I understand it, to institute a civil suit against a failed bank's board of directors in an effort to recoup revenues for the insurance fund that they might recoup from directors.

If this current policy is continued, you're going to be picking up a lot of directors who apparently have not breached their fiduciary duty as directors but are simply victims of the economy.

Are there cases where the FDIC attempts to make distinctions between those directors who've, obviously, breached their fiduciary duty to the stockholders and to others and those who are not; those who really might be helpless victims who've done their best but they're simply victims of circumstance and the economy.

Mr. ISAAC. I think we make that distinction. We sue directors only when we find either willful misconduct or serious neglect of duty.

Perhaps subsequent events and the evidence brought out at a trial will show that we've brought a suit improperly, in which case we'd drop it, but we certainly don't go into any suit believing that we are suing someone who is not guilty of negligence or willful misconduct; we don't sue them just because they happen to be on the board.

Senator SASSER. It's not the policy of the FDIC then to institute blanket lawsuits against everybody on the board of failed banks?

Mr. ISAAC. That is definitely not our policy and there are a number of institutions where we have not brought suit. And in cases where we do bring suit, we typically take 6 months to 1 year before bringing the suit so we can complete the investigation as to why the bank failed and who was at fault.

Senator SASSER. Mr. Chairman, I've got some more questions on behalf of myself and of other Senators but we're running out of time and I'm going to run vote and turn it over to Senator Riegle.

Senator RIEGLE. I've got to go vote, too, or we're going to miss the vote.

I just want to ask you to respond to one question and that is you mentioned the reforms in the deposit insurance system as the single most important item that you see that's needed. I'd like to know specifically what you think we ought to do.

Mr. ISAAC. First of all, we ought to have a system of risk-related deposit insurance premiums.

Senator RIEGLE. Risk-related deposit insurance premiums, No. 1, OK. What else?

Mr. ISAAC. Our proposal for risk-related premiums, incidentally, is supported by the FSLIC, by the Bush Task Force, by the Cabinet Council on Economic Affairs, and by the American Banker's Association, in addition to the FDIC. So I think it's time to get on with risk-related premiums to help instill a little discipline and bring a little more fairness into the way we charge for deposit insurance.

There are a host of other issues that we have presented in our deposit insurance legislation. Some of them that come to mind are to set a national priority statute when a bank fails. Right now, we're governed by the laws of 50 different States on which creditors get what when.

Senator RIEGLE. Right.

But let me ask you to do this. I really—I hate getting trapped on the second bells of the vote that I'm about to miss and I need to make this vote because I'm a cosponsor of the amendment, among other things.

But, I'd like you to give me as full an answer as you can on this because I want to see us make what changes seem to be needed in the area of deposit insurance, and so as you're leaving this assignment, I think you're in a position to really help us map that out and so I'd like as detailed an answer as you can give.

Mr. ISAAC. I'll be happy to.

Senator RIEGLE. Thanks very much.

[Recess.]

[Response to written questions of Senators Garn, Gorton, Boren, Reigle, and Sasser from William M. Isaac follow:]



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

July 11, 1985

Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

You have asked that I supplement my testimony of May 8, 1985 by responding to written questions from yourself, Senator Gorton, and Senator Boren. I am pleased to submit the following.

ANSWERS TO QUESTIONS FROM SENATOR GARN

QUESTION 1: Please provide to the Committee an analysis of bank failures over the past 3 years as well as a forecast of the number of future failures.

ANSWER: Over the past several years bank failures have been the result of various factors which have affected the asset quality of the institutions involved. Principal among them have been fraud, insider abuse and bad management. These problems are more likely to come to the surface in a poor economic environment, which also has been a major contributor. We experienced more than a decade of accelerating inflation (which distorted investment and credit decisions), followed by extremely high and volatile interest rates and two back-to-back recessions (the second one, the most severe in 50 years). Although the recession has long since ended, certain parts of the economy (in particular, energy, agriculture and real estate) have not enjoyed the full benefits of recovery. In addition, the dramatic reduction in the rate of inflation has caused difficulties for some groups which implemented business decisions on the expectation of continued levels of high inflation. The continuing massive deficits have contributed greatly to very high real interest rates and a high-priced dollar, causing pressures on a number of banks and thrifts and their customers. Also, many of the small bank failures, particularly in agricultural states that restrict branching, are due in some measure to their inability to diversify their portfolios. Finally, there is the problem of money brokers dumping hundreds of millions of dollars of fully insured funds into troubled banks and thrifts based solely on the rate of interest paid.

- 2 -

Since 1982 there have been 220 bank failures: 42 in 1982; 48 in 1983; 79 in 1984; and 51 through June 25 of this year. For the most part, the failures have been relatively small banks (see Table 1), with 172 having assets of less than \$50 million.

Geographically, the failures have been more predominant in areas with known economic problems; that is, California (real estate), Texas and Oklahoma (energy), the Midwest (agriculture), Oregon (agriculture and forestry) and Tennessee (Butcher-related). The geographical distribution of bank failures since 1982 is shown in Figure 1.

In recent years the number of banks on our problem list has been increasing. For year-end 1982, 1983 and 1984 the respective number of banks on this list was 369, 642, and 848. Currently there are about 975 banks on the list, and we expect this number to be in the 1,100 to 1,200 range by year-end 1985. It is difficult to make projections much beyond that date, though we currently expect the number to rise during 1986.

The number of problems suggests an increase in failures. Based on figures thus far in 1985 and the size of our problem list, we expect to experience over 100 failures this year. We are currently projecting at least that many failures in 1986.

TABLE 1: SIZE DISTRIBUTION OF FIDC-INSURED
BANK FAILURES, 1982 THROUGH JUNE 25, 1985

Asset Size	Number	Percent
Less than \$50 Million	172	78.2%
\$50 to \$100 Million	15	6.8%
\$100 to \$300 Million	18	8.2%
Greater than \$300 Million	<u>15</u>	<u>6.8%</u>
Total	220	100.0%

NOTE: Asset size is as of the most recent call date before failure.

QUESTION 2: Many analysts claim that commercial and personal loans are in the process of being "securitized". They point to commercial paper, mortgage backed securities, auto loans, and junk bonds. They predict that this trend will increase. Do you agree with this analysis and forecast? If so, what does this imply for the future earning capacity of bank holding companies?

- 3 -

ANSWER: It is clear that the trend in the financial markets has been toward more innovation and sophistication. The results have been the introduction and expanded use of financial instruments which act as substitutes for lending traditionally provided by commercial banks. This has been the case particularly in the low-risk, low-margin areas of lending where commercial banks have found it increasingly difficult to compete with alternative sources of financing (as is the case with commercial paper).

This increased external competition will, in the long run, have an impact on banks and bank holding companies. As these more traditional lines of business are lost to alternative funding sources, it is important that banks be able to look toward other sources of income and not be bound by artificial constraints. In light of deposit deregulation and increased financial competition, it is important that we provide banks with new avenues in which to diversify and enhance earnings.

QUESTION 3: Mr. Budd of Travelers Insurance Company testified that it would have been irresponsible for Travelers not to have activated its bank charter in view of the thrust and strategic announcements that many of Travelers' competitors have made. Given the changes occurring in the financial services marketplace, would it be irresponsible not to permit banks and bank holding companies to respond to the marketplace and their competitors by expanding their product lines to the extent you have suggested in your testimony? What are the risks to the financial system as a whole and banks specifically, if Congress does not authorize product and service flexibility?

ANSWER: We believe banks should be authorized to engage in a broader range of financial activities for two principal reasons. First, it would be procompetitive. The American public -- including consumers, small businesses and farmers -- would be given a broader range of financial products at more competitive prices. Second, it would strengthen the banking system by allowing banks to be more competitive in the financial marketplace, develop new sources of income to help offset the cost of liability deregulation, and achieve a degree of diversification commensurate with their nonbank competitors.

As a practical matter, the marketplace is deregulating the financial services industry. Choosing between deregulation and re-regulation is not an option. Our responsibility, and our only choice as public officials, is to protect the public interest by attempting to provide for more orderly deregulation than the unplanned, helter-skelter de facto deregulation in progress.

Many of the powers or services at issue -- insurance, securities and real estate brokerage or agency activities -- can hardly be characterized as risky; thus, few, if any, regulatory safeguards are needed to protect banks that are permitted to offer these services. Activities such as insurance or securities underwriting and real estate investment, that we believe involve more risk, should be separated from the bank itself and not be underwritten by federal deposit insurance. These activities should be permitted to be carried on in separately capitalized and funded subsidiaries or affiliates of banks.

The FDIC has issued final regulations governing an insured nonmember bank's securities underwriting activities which would confine such activities to separately capitalized and funded subsidiaries of these banks. (See answer to Question 6 for more detail on restrictions that apply to a bank's securities subsidiary.) In addition, a proposal has been released by the FDIC for public comment concerning the potential use of such subsidiaries for a bank's insurance underwriting and real estate development activities.

QUESTION 4: Mortgage credit in this country once was provided almost exclusively by traditional depository institutions that held mortgages until their maturity. Today, more and more mortgages are sold to investors in the secondary market.

A similar development has occurred in the provision of commercial credit. Whereas commercial banks were once the almost exclusive providers of commercial credit, the commercial paper market has enabled corporations to acquire commercial credit by selling their debt directly to investors.

Would you agree that explicit authorization for banks to underwrite mortgage-backed securities and commercial paper is needed to preserve their traditional role in the provision of mortgage credit and commercial credit? Why?

ANSWER: The commercial paper market provides short-term funding to large corporations with solid credit ratings. This market has developed as corporations found they could raise funds less expensively by going directly to the markets rather than obtaining funding through a commercial bank. The mortgage-backed securities market provides a convenient mechanism for investing in mortgages without the burden of servicing. Mortgage-backed securities have been purchased heavily by depository institutions and other financial institutions.

The inability to underwrite mortgage-backed securities or commercial paper diminishes the role of commercial banks in the areas of mortgage and commercial credit. As discussed in the answer to Question 2, it is important that the broad issue of bank powers be addressed in order to maintain the long-term viability of the banking system. These two financial service activities are among the many where bank entry is prohibited. Such prohibitions, especially when taken in the aggregate, reduce competition and the viability of banks.

QUESTION 5: Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment activities than commercial banks in the U.S.

Are you aware of serious safety and soundness problems that have arisen from this combining of investment banking and commercial banking in London?

If a financial institution in London can offer both commercial and investment banking services to a corporate customer, does that financial institution in London have a competitive advantage over a financial institution in the U.S. that can offer only one of the services?

ANSWER: We are not aware of any safety and soundness problems that have arisen in London from the combination of investment banking and commercial banking. Moreover, we seriously doubt that any problems will arise because of the combination of the two types of activities. Historical experience in the U.S. provides a basis for this judgment. Careful reading of the Pecora hearings, which set the stage for passage of the Glass-Steagall Act, show that no evidence was presented to indicate that the combination of investment and commercial banking powers in the U.S. contributed in any way to the banking crisis of the 1930s.

What the hearings did illustrate were: (1) abuses common to the entire investment banking industry, such as the dissemination of untruthful or misleading information; (2) abuses that were attributed to the use of securities affiliates for the personal profit of bank officers and directors; (3) conflicts of interest that resulted from the mixing of commercial and investment banking functions. While such problems were certainly cause for concern, they had nothing to do with any inherent safety and soundness risks associated with a combination of the two types of activities, and could have been controlled by far less stringent means than an absolute separation between commercial and investment banking. We believe that our regulation governing an insured nonmember bank's securities activities sufficiently insulates these banks from any safety and soundness risks posed by their securities-related activities.

QUESTION 6: Chairman Volcker suggested that the Glass-Steagall Act be amended to cover thrifts and state nonmember banks. Do you agree? Under present regulations, what safeguards do you have in place? Would you recommend that Congress extend your regulations to all insured banks?

ANSWER: As suggested in the answer to Question 5, it is the FDIC's view that the current inequity would best be remedied by repealing the Glass-Steagall Act so that national and state member banks are not prohibited from combining investment banking with their commercial banking activities.

FDIC regulations require that a state nonmember bank's securities underwriting activities be conducted in a subsidiary that: (1) is physically separate and distinct from the bank; (2) is separately and adequately capitalized and funded; (3) does not share a common name or logo with the bank; (4) maintains separate accounting and other corporate records; (5) observes separate formalities such as board of directors' meetings; (6) maintains separate employees that are compensated by the subsidiary; (7) shares no common officers with the bank; (8) has a majority of its board of directors composed of persons who are neither officers nor directors of the bank; and (9) conducts business pursuant to independent policies and procedures designed to inform customers that the subsidiary is a separate organization from the bank, and that its investments are not bank deposits and are not insured by the FDIC.

It is our view that these are adequate safeguards and could be extended to cover all insured banks and bank holding companies.

QUESTION 7: If interstate banking were to be permitted, would the FDIC's ability to handle failures through mergers decline substantially? If so, how would you propose handling bank failures? If more payouts will be commonplace, will the size of the insurance fund need to be a higher percentage of insured deposits?

ANSWER: The FDIC's ability to handle failures through mergers would increase if interstate banking were permitted. The current prohibition on interstate banking presents a significant constraint on the FDIC's ability to effect a successful merger because it limits the number of potential bidders for failed banks. Many of the deposit payoffs over the years resulted because there were no bidders for the failed bank. In other cases there were few bidders and the highest bid was not large enough to warrant a merger on the basis of the FDIC's cost test (which is used to determine whether a merger or a deposit payoff is to be effected). The potential for out-of-state bidders would not always guarantee that an acceptable bid would be received, but surely the probability of obtaining such a bid would increase. Our studies show a clear and definite correlation between the number of bidders and the size of the winning bid.

The beneficial effect of interstate banking would be particularly noticeable for large bank failures. By necessity, the larger the bank, the fewer the number of potential in-state bidders.

In many instances troubled banks are merged into healthy banks without FDIC assistance and, as a result, bank failures are forestalled. Interstate banking would increase the potential for such mergers and very likely reduce the number of bank failures.

QUESTION 8: In your testimony you indicated that there are thousands of banks owned by automobile dealers, insurance agents, retailers, etc. Do you have any statistics on these operations - as to number and quality of operation? Are these institutions more or less likely to fail?

ANSWER: In our dealings with commercial banks, we have found that it is not unusual for people who own automobile dealerships and other businesses to also own banks. This results in an informal link between the nonbanking interest and the bank itself, although that link is not subject to disclosure and public scrutiny. Since we do not maintain this type of ownership information on our data files it would be difficult to do the requested analysis on these institutions. In our judgment, it would be far preferable to have affiliations of this sort out in the open, expressly authorized and subject to reporting requirements and other prudential rules.

QUESTION 9: In your testimony you indicated that 50% of the failures have occurred due to insider abuse. Are any changes in the law necessary to help the agencies in this area - removal authority, civil money penalty, criminal law? Should bank officers be licensed by the agencies with the power to revoke that license? Would this help agencies stop a poor bank executive from becoming a poor savings and loan executive and vice versa?

ANSWER: The FDIC does not feel that it is necessary to license bank officers. The Change in Bank Control Act and our examination and enforcement powers generally give us the authority we need to keep undesirable people out of banking.

It should be noted that the FDIC has requested additional enforcement authority over national and state member banks, as recommended by the Bush Task Group. Our current authority over these institutions extends only to the removal of insurance, a rather drastic measure. Additionally, the FDIC's deposit insurance reform bill would expedite the processing of enforcement actions, while maintaining due process safeguards, and would expand the authority to remove officers and directors.

QUESTION 10: Some have suggested that the appropriate method for federal agencies to curtail excessive use of products and services by state chartered institutions is to establish maximum aggregate and individual limitations on each authority. What is your view? What limits for specific authorities would you recommend?

ANSWER: The FDIC believes that in certain instances limitations can have some value in ensuring adequate diversification and reducing a bank's overall risk exposure. For example, limitations have been proposed by the FDIC on an insured bank's involvement in real estate development activities. A notice of proposed rulemaking was published in the Federal Register on June 11, 1985. As it currently stands the regulation would limit an insured bank's real estate development investment to 50 percent of primary capital. The bank's aggregate investment in any one real estate development (including extensions of credit) could not exceed 10 percent of the bank's primary capital. Any real estate investments over and above the proposed limits would have to be transacted through a bona fide subsidiary of the bank. A bank's investment in the subsidiary would not be counted toward the bank's capital requirement, and other prudential rules have been proposed to limit intercompany transactions. Similarly, the proposed rule provides that insurance underwriting activities may be conducted only through separately funded and capitalized subsidiaries. As noted previously, the FDIC issued final regulations governing the securities underwriting activities of insured nonmember banks in November, 1984. These regulations state that insured nonmember banks should only be permitted to engage in securities underwriting activities through subsidiaries that meet certain safeguards.

ANSWERS TO SENATOR BOREN

QUESTION 1: Chairman Isaac, you have stated that there are now more banks on the troubled list than at any time in history, some 949 banks. What effect do you think the new, recent regulations - allowing the FDIC to make public enforcement actions against such banks - will have on these institutions? Is it possible that if certain information about a troubled bank is disclosed, the confidence of depositors could be shaken to the extent that runs on banks could result?

ANSWER: Your first two questions are closely related so we will respond to them together.

The policy recently adopted by the FDIC's Board of Directors of routinely disclosing to the public all final orders issued to banks and bank officials in connection with statutory enforcement actions taken by the FDIC becomes effective next January 1. In our view, this new policy will promote public understanding of, and confidence in, the banking system by providing significant and meaningful information regarding the condition and practices of banks. At the same time, an objective of the policy is to deter bankers from engaging in unsafe and unsound practices.

We do not foresee that the FDIC's disclosure of enforcement actions will result in an erosion of public confidence in our financial system. Those who would prefer to cloak themselves in a veil of secrecy raise this issue whenever a disclosure proposal is advanced. Similar concerns were expressed over a decade ago when banks and bank holding companies registered under the securities laws were required to disclose enforcement actions; when the FDIC proposed in 1972 to make available to the public Reports of Condition and Income; and, more recently, when the banking agencies two years ago expanded the Report of Condition to include information about nonperforming loans and make that information available to the public. Concerns in all those cases have proved to be unfounded. Public confidence in the banking system is enhanced when the public receives fair and meaningful disclosure, and confidence is eroded when the public believes it is being deceived or is not receiving all the facts it needs to evaluate a situation.

Fewer than 400 nonmember banks are subject to formal enforcement actions and many of them are already required to disclose the enforcement actions under the securities laws or under a standard provision included in FDIC orders. In addition, the FDIC has been making its orders available upon specific request under the Freedom of Information Act since 1976. Moreover, a bank may avoid any possible adverse consequences of public disclosure of an enforcement action by conducting its business in a safe and sound manner or by correcting any problems promptly and voluntarily, without the necessity of a formal action.

We believe that better disclosure will result in a stronger, more stable banking system that experiences fewer and less costly failures. Particularly in a deregulated interest rate environment in which deposits tend to flow to the highest bidder -- which all too often is a troubled bank or thrift -- meaningful disclosure is one of the best protections available to the vast majority of banks that are prudently operated.

QUESTION 2: As you will soon be leaving your position as FDIC Chairman what advice will you leave as to consolidation of federal deposit insurance?

ANSWER: In 1983, the FDIC submitted a study to Congress entitled Deposit Insurance in a Changing Environment, which contained recommendations for the deposit insurance system. Commercial banks and thrifts are becoming nearly indistinguishable in their powers and functions. These institutions also are

beginning to come together in larger financial organizations, a trend likely to accelerate in the future. It is therefore difficult to rationalize that the insurance funds of the FDIC and FSLIC should continue to be separately maintained. The financial services industry, as it is evolving, requires a unified system which would provide a stronger fund with a more diversified risk-base, equality in deposit insurance coverage, more coordinated supervision (including uniform accounting, disclosure and capital standards) and greater flexibility in dealing with troubled or failed banks and thrifts (including inter-industry mergers).

QUESTION 3: Are there any instances that the FDIC as receiver has disclosed a "detailed" list of expenditures it has made in liquidating assets of a closed bank? Since the FDIC will see that enforcement actions against banks are made public, and banks already must provide a great deal of public financial disclosure, what is the FDIC's rationale for keeping its detailed liquidation expenses private, as in the case of the Penn Square Bank?

ANSWER: It is the FDIC's practice to provide press releases and informal status reports to all inquiries from the general public, creditors, stockholders and members of Congress when interest is expressed. This includes general information about the closing, status of claims, liquidation income, litigation and a breakdown of receivership expenses.

In the case of the Penn Square Bank, we are issuing regular status reports on the liquidation, which contain breakdowns of the expenses associated with it, and have given more detailed reports of expenses to certain members of Congress. We have, in fact, provided more information on the Penn Square liquidation than we have provided to anyone on any of the hundreds of liquidations that we have conducted or are conducting. Over the past few years, in both correspondence and personal meetings, we have demonstrated to members of the Oklahoma delegation, that our operating procedures are conducted economically and for the best interest of the insured depositors and other creditors.

Members of the Oklahoma delegation have persisted in requests that we provide individual vouchers -- or some similar detail -- showing individual expenses for hotel rooms, airline tickets, car rentals, etc. Because of the way our recordkeeping is done, these items are grouped under the consolidated heading of travel and to break them out would require months of work and an estimated expenditure of \$60,000.

It is our judgment that no useful purpose would be served by diverting the very scarce human resources available to us to respond to such a request. Nor do we think the uninsured depositors would be well-served by diverting funds collected for their benefit for this purpose. We have, therefore, declined the request for detailed listings of expenses unless the receivership court overseeing our efforts determines that this would be an appropriate way to utilize the people and financial resources of the Penn Square receivership.

However, we assure you that the FDIC is very concerned with minimizing expenses of all liquidations. At the same time, we fully recognize our duty to keep the public informed. We will continue to make every effort to meet this responsibility. Moreover, as I said last year at a forum in Oklahoma City, we will be pleased to provide information on any specific item of expense on request. Thus far, we have received no such request.

QUESTION 4: The National Bank Act and the FDI Act, in different sections of the U.S. Code, call for liquidation expenses of the FDIC to be mandatorily and optionally taken from the receivership, respectively. In an effort to bring these two contradictory statutes into unison, which one would the FDIC prefer be changed and why?

ANSWER: In our view, the National Bank Act (NBA) and the FDI Act do not contain contradictory provisions regarding the payment of the FDIC's liquidation expenses. Presumably, the sections of those Acts to which you allude are the following:

1. NBA: 12 U.S.C. Section 196, which states that " . . . all expenses of any receivership shall be paid out of the assets of such association before distribution of the proceeds thereof." (emphasis supplied)
2. FDI Act: 12 U.S.C. Section 1822(A), which states that " . . . expenses of liquidation and the administration thereof shall be fixed by the Corporation, and may be paid by it out of funds coming into its possession as such receiver." (emphasis supplied)

The FDI Act's use of the word "may" should not be read to create an option for the FDIC regarding payment of liquidation expenses, since the Act nowhere provides that the FDIC can either waive payment of such expenses or charge them to the insurance fund. Penn Square is a national bank receivership and the FDIC is bound by 12 U.S.C. Section 196.

Even if the FDIC had the discretion not to charge its expenses against the Penn Square receivership (which it clearly does not), we would be totally opposed to doing so. The handling of our expenses at Penn Square is in accord with our procedures in hundreds of other receiverships. We could not justify a change in our procedures at Penn Square without changing our procedures at all other receiverships, which is something we simply cannot do.

ANSWERS TO SENATOR GORTON

QUESTION: I am told that a majority of failed banks had "CAMEL" ratings of 1 or 2 on the call report most immediately preceding their closure. If true, this has profound implications for the ability of bank examiners to spot and deal with problems. Can you confirm this allegation? Can you supply for the record what the CAMEL ratings were for those banks under your jurisdiction which have failed? How do you explain those instances where the previous exam did not disclose the institution's danger of failure?

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ANSWER: A Uniform Financial Institutions Rating, a.k.a. "CAMEL" is assigned each bank based on an evaluation of pertinent financial, operational and management information gained in the examination of the bank or other interim sources. The rating is not derived from or reflected on the call reports submitted by each bank, nor is it publicly disclosed.

Our examination process includes not only full examinations but also visitations, lesser and more directed in scope than full examinations, and offsite reviews of pertinent bank information conducted at our Regional Offices. In the case of problem institutions, reviews also take place at our Washington office.

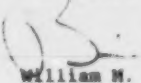
Although the first priority of our examination program is effective surveillance and supervision of banks warranting more than normal supervisory concern, we maintain regular surveillance of sound well-run institutions through combinations of the aforementioned activities of the examination process and initiate supervisory actions as necessary.

A list of banks which failed in 1984 and through June 11, 1985 and their "CAMEL" ratings as of the date of failure and as of the two previous examinations is attached. All but two banks were rated 5 when they failed, the other two rated 4. Not reflected on the list are examinations in process at the time of closing, visitations and offsite reviews conducted between examinations or other supervisory actions conducted independently or jointly by the FDIC and a bank's primary regulator. Also not shown are cease-and-desist or other formal enforcement orders levied by the FDIC or primary regulator.

In the case of state nonmember banks rated 4 or 5, it is the policy of our Division of Bank Supervision that, in addition to full examinations, visitations be conducted at a minimum on a quarterly basis. The policy also requires, at a minimum, visitations or offsite reviews of state nonmember banks rated 1 and 2, and banks rated 3 each 12 months and 6 months, respectively, in addition to full examinations. The FDIC and a bank's primary regulator closely coordinate supervisory efforts regarding banks warranting more than normal supervisory concern. Again, ratings are assigned as a result of the supervision process which we believe is effective in disclosing the condition of banks and reflecting the degree of continued viability.

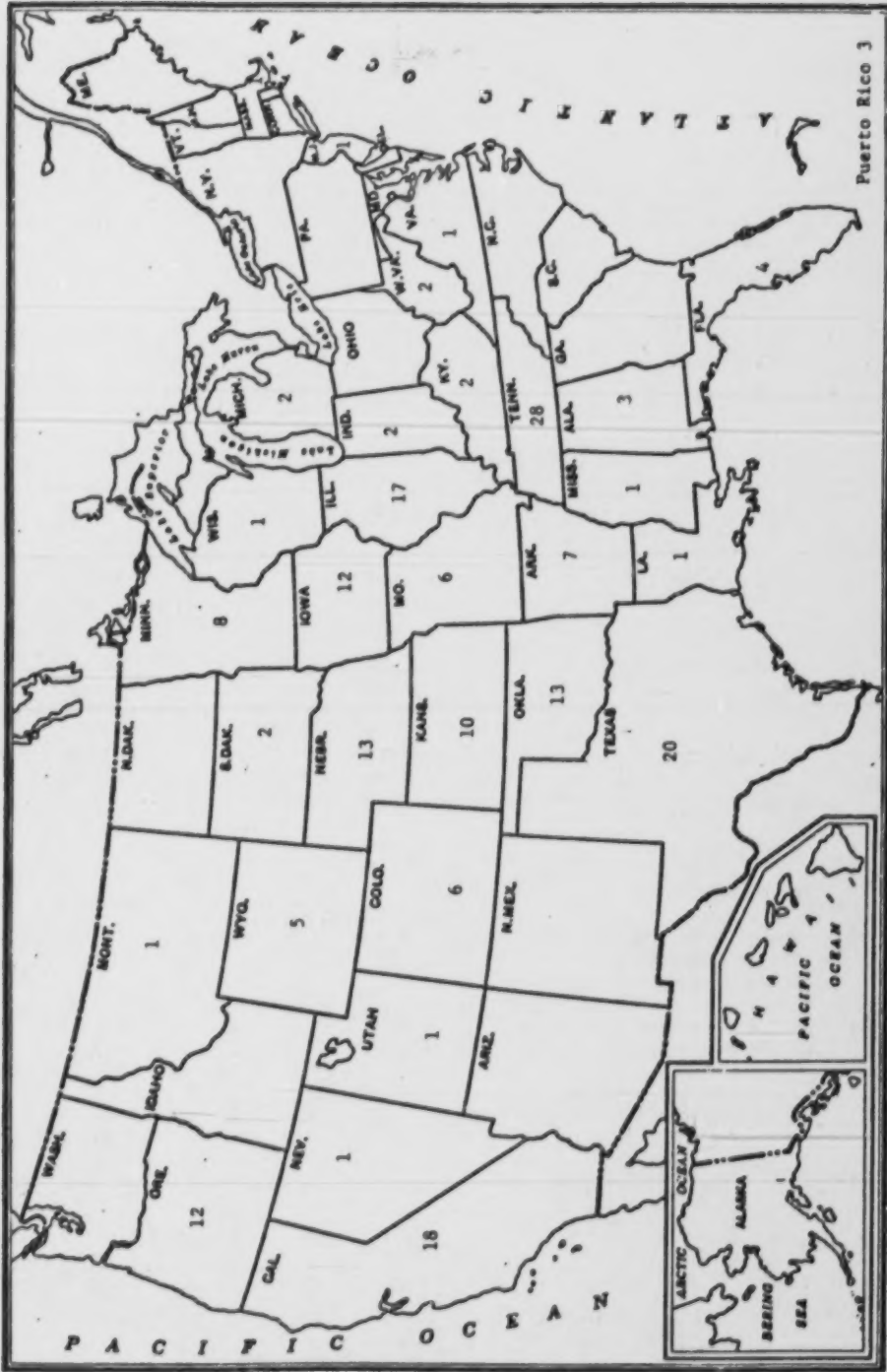
There are instances where fraud, embezzlement or other criminal misconduct resulted in the failure of a bank rated 1 or 2. Such acts can result in extensive damage in a short period of time and can be difficult to detect, especially by offsite review and monitoring programs. Apart from these situations, the "CAMEL" rating system is a reliable barometer of bank performance.

Sincerely,


William M. Isaac
Chairman

Attachments

FIGURE 1: COMMERCIAL BANK FAILURES BY STATE, 1982 THROUGH JUNE 20, 1985.



NOTE: States without numbers have had no failures.

Answer to question to Senator Carn - Figure 1.

1985

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING			
		AT CLOSING	LAST TWO EXAMINATIONS		
1. Citizens State Bank Edgerton, WY	1-4-85 2,831	5	11-2-84 5-18-84	5 4	
2. State Bank of Dannebrog Dannebrog, NE	1-7-85 4,318	5	2-9-84 3-11-83	4 3	
3. Coast Community Bank Harbor, OR	1-11-85 9,054	5	9-10-84 4-20-84	5 4	
4. The First National Bank in Marlow Marlow, OK	1-24-85 27,451	5	5-31-84 9-30-83	5 4	
5. First National Bank in Clarksville Clarksville, TX	1-24-85 29,248	5	11-2-84 4-13-84	5 4	
6. The Steele State Bank Cherokee, IA	1-25-85 19,277	5	11-23-84 5-11-84	5 4	
7. Citizens Fidelity Bank Bristol, TN	2-1-85 16,360	5	10-1-83 7-3-81	4 2	
8. First National Bank Bank of Woodbine Woodbine, IA	2-7-85 26,774	5	9-30-84 7-23-82	5 2	
9. Farmers National Bank of Erick Erick, OK	2-7-85 17,659	5	5-31-84 10-21-83	4 3	
10. Peoples Bank and Trust Company Wartburg, TN	2-8-85 23,122	5	1-21-84 4-29-83	5 5	
11. West Valley Bank Woodland Hills, CA	2-8-85 41,169	5	10-12-84 7-29-83	5 3	
12. First National Bank of Eads Eads, CO	2-14-85 16,906	5	6-30-84 5-31-83	4 3	

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1985

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING			
		AT CLOSING	LAST TWO EXAMINATIONS		
13. Citizens State Bank of Fulda Fulda, MN	2-5-85 38,095	5	11-26-84 3-23-84	5 4	
14. Inwood State Bank Inwood, IA	2-19-85 7,094	5	12-31-84 12-17-82	5 2	
15. Halifax National Bank of Port Orange Port Orange, FL	3-1-85 38,234	5	5-28-82 11-30-80	1 1	
16. Citizens State Bank Arapahoe, NE	3-8-85 15,675	5	7-12-84 1-20-84	4 4	
17. Commercial State Bank Afton, IA	3-8-85 15,988	5	9-28-84 4-23-84	5 4	
18. Taylor State Bank Emington, IL	3-15-85 4,789	5	11-20-84 3-16-84	5 5	
19. Golden Valley Bank Turlock, CA	3-22-85 72,291	5	1-11-85 8-20-84	5 5	
20. Fidelity Bank of Denver Denver, CO	3-29-85 43,979	5	11-30-84 6-29-84	5 5	
21. The Bank of Hunter Hunter, OK	4-4-85 2,860	5	9-28-84 10-21-83	5 5	
22. Capistrano National Bank San Juan Capistrano, CA	4-5-85 51,102	5	12-31-84 5-31-84	5 5	
23. State Bank of Alexandria Alexandria, NE	4-11-85 2,559	5	11-6-84 8-13-82	5 2	
24. First State Bank of Elgin Elgin, OR	4-12-85 17,778	5	3-16-84 10-28-83	5 5	

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1985

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING		
		AT CLOSING	LAST TWO EXAMINATIONS	
25. South Coast Bank Costa Mesa, CA	4-12-85 31,737	5	10-31-84 3-12-84	5 5
26. Peoples National Bank of Lampasas Lampasas, TX	4-18-85 33,854	5	8-31-84 12-30-83	5 5
27. The First National Bank of Springfield Springfield, CO	4-18-85 15,274	4	3-30-84 8-31-83	4 4
28. Peoples State Bank Odebolt, IA	4-26-85 13,294	5	11-9-84 10-14-83	4 2
29. First Enterprise Bank Oakland, CA	4-26-85 40,803	5	11-29-84 2-29-84	5 4
30. The Bank of Commerce Chanute, KS	5-2-85 67,131	5	3-12-84 2-16-83	4 3
31. Farmers Savings, Bank Massena, IA	5-3-85 66,102	5	7-6-84 11-21-83	3 3
32. Farmers State Bank, St. Joseph St. Joseph, MO	5-3-85 49,585	5	10-15-84 4-9-84	5 4
33. Story County State Bank Story City, IA	5-9-85 32,654	5	2-22-85 11-2-84	5 5
34. Bank of Newcastle Newcastle, OK	5-16-85 31,118	5	3-8-85 7-18-84	5 4
35. The Energy Bank, National Association Dallas, TX	5-16-85 30,693	5	4-22-85 7-31-84	5 5
36. Northwest Bank White Settlement, TX	5-23-85 51,906	5	5-3-85 9-28-84	5 3

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1985

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING	
		AT CLOSING	LAST TWO EXAMINATIONS
37. Bank of Taylor Taylor, NE	5-31-85 13,829	5	10-26-84 4 11-15-83 4
38. Bank of Lockesburg Lockesburg, AR	5-31-85 27,171	5	12-7-84 4 3-5-84 2
39. The Bank of Oregon Woodburn, OR	5-31-85 108,756	5	12-31-84 5 5-31-84 5
40. First Trust Bank of Lakefield Lakefield, MN	5-31-85 23,849	5	3-29-85 5 1-3-84 4
41. Fairfield State Bank Fairfield, NE	6-2-85 6,184	5	4-23-85 5 9-7-82 2
42. Scroggin and Company Bank Oak, NE	6-2-85 3,219	5	4-26-85 5 7-2-82 2
43. Security State Bank Edgar, NE	6-2-85 5,785	5	4-29-85 5 12-5-84 3
44. American National Bank of Riverton Riverton, WY	6-11-85 36,827	5	1-31-85 5 6-29-84 5

1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING	
		AT CLOSING	LAST TWO EXAMINATIONS
1. Farmers Bank & Trust Company Winchester, TN	1-6-84 48,614	5	4-4-83 5 7-13-81 1
2. City & County Bank of Jefferson County White Pine, TN	1-20-84 22,238	5	1-24-83 4 9-14-82 3
3. Indian Springs State Bank Kansas City, KS	1-27-84 27,942	5	12-10-82 4 2-26-82 2
4. Emerald Empire Banking Company Springfield, OR	2-3-84 20,529	5	2-28-83 4 4-16-82 2
5. Tucker County Bank Parsons, WV	2-3-84 16,447	5	11-18-83 5 7-18-83 5
6. Heritage Bank of Bureau County Depue, IL	2-8-84 8,661	5	11-18-83 5 7-29-83 3
7. West Olympia Bank Los Angeles, CA	2-10-84 18,898	5	9-2-83 5 2-23-83 5
8. Brownfield State Bank and Trust Company Brownfield, TX	2-17-84 38,201	5	8-5-83 5 11-26-82 4
9. United Bank of Oregon Milwaukie, OR	3-2-84 16,192	5	4-15-83 5 3-26-82 4
10. All American National Bank Virginia Gardens, FL	3-2-84 13,313	5	5-31-83 3 10-29-82 3
11. National Bank & Trust Company of Traverse City Traverse City, MI	3-9-84 78,677	5	9-29-83 5 12-31-82 4

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1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING		
		AT CLOSING	LAST TWO EXAMINATIONS	
12. Heritage Bank Anaheim, CA	3-16-84 157,840	5	6-30-83 3-31-83	5 5
13. Seminole State National Seminole, TX	3-16-84 47,996	5	8-5-83 6-19-81	5 2
14. Wautaga Valley Bank Elizabethton, TN	4-6-84 13,389	4	2-28-83 3-9-81	4 2
15. First Security Bank Erwin, TN	4-6-84 23,800	5	2-28-83 7-6-81	5 2
16. Security National Bank of Lubbock Lubbock, TX	4-13-84 48,200	5	8-5-83 5-20-83	5 4
17. Gamaliel Bank Gamaliel, KY	4-19-84 22,564	5	4-7-84 8-26-83	5 4
18. The Shelby National Bank of Shelbyville Shelbyville, IN	4-19-84 64,226	5	10-31-83 4-30-83	5 4
19. United of America Bank Chicago, IL	4-26-84 34,232	5	11-30-82 12-31-81	5 4
20. West Coast Bank Los Angeles, CA	4-27-84 185,593	5	4-1-83 1-13-83	5 4
21. Citizens Bank of Monroe County Tellico Plains, TN	4-27-84 20,525	5	2-4-84 1-24-83	5 4
22. First National Bank of Snyder, TX Snyder, TX	5-4-84 20,475	5	8-5-83 5-22-81	4 1

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1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING		
		AT CLOSING	LAST TWO EXAMINATIONS	
23. The First National Bank of Rushford Rushford, MN	5-4-84 21,608	5	1-26-84 7-15-83	5 4
24. Western National Bank of Casper Casper, WY	5-4-84 24,266	5	9-30-83 3-7-83	4 3
25. State Bank of Mills Mills, WY	5-4-84 6,845	5	4-8-83 11-2-81	2 1
26. The National Bank of Carmel Carmel-By-The-Sea, CA	5-8-84 96,828	5	4-27-84 9-30-81	5 2
27. The Mississippi Bank Jackson, MI	5-11-84 241,270	5	2-18-83 1-22-82	4 3
28. First Continental Bank & Trust Company of Del City Del City, OK	5-11-84 110,471	5	7-8-83 8-25-82	5 5
29. Bank of Irvine Irvine, CA	5-18-84 30,661	5	9-3-83 12-3-82	5 5
30. Planters Trust & Savings Bank of Opelousas Opelousas, LA	5-18-84 67,183	5	2-11-83 2-19-82	4 4
31. Bledsoe County Bank Pikeville, TN	5-18-84 5,128	5	3-16-84 4-26-83	5 5
32. Washington National Bank of Chicago Chicago, IL	5-18-84 15,020	5	9-27-83 2-28-82	5 1
33. First National Bank of Prior Lake Prior Lake, MN	5-24-84 14,283	5	3-15-83 (Opened 10-21-82)	2 2
34. Garden Grove Community Bank Garden Grove, CA	6-1-84 39,485	5	1-27-82 5-19-81	3 2

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1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING	
		AT CLOSING	LAST TWO EXAMINATIONS
35. Cherokee County Bank Centre, AL	6-5-84 38,780	5	7-9-83 4 6-1-82 3
36. Stewardship Bank Portland, OR	6-8-84 5,823	5	4-27-84 5 4-29-83 4
37. The Corning Bank Corning, AR	6-15-84 35,519	5	9-6-83 4 9-13-82 4
38. Farmers State Bank Lyons, SD	6-15-84 3,227	5	2-24-84 4 6-10-83 4
39. The Lawrence County Bank Lawrenceburg, TN	6-15-84 24,344	5	3-31-84 5 11-18-83 5
40. Republic Bank of Kansas City Kansas City, MO	6-18-84 42,268	5	11-25-83 4 5-16-83 3
41. The Farmers National Bank of Aurelia Aurelia, IA	6-20-84 19,413	5	9-30-83 5 1-31-83 4
42. American Bank St. Joseph, TN	6-27-84 35,399	5	12-14-81 2 3-17-80 2
43. East Texas Bank & Trust Company Longview, TX	6-29-84 99,746	5	4-6-84 5 3-16-83 2
44. Coffeen National Bank Coffeen, IL	7-12-84 9,601	5	11-18-83 5 10-31-83 5
45. Guaranty Bank of St. Paul St. Paul, MN	7-20-84 27,477	5	1-30-84 5 2-1-83 4
46. Coalmont Savings Bank Coalmont, TN	7-24-84 25,218	5	10-26-81 1 3-24-80 1

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1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING	
		AT CLOSING	LAST TWO EXAMINATIONS
47. Jackson County National Bank Tuckerman, AK	8-9-84 14,000	5	10-31-83 5 7-30-82 4
48. Peoples State Bank of Clay County Poland, IN	8-10-84 13,057	5	8-27-83 5 12-11-82 4
49. The Tingley State Savings Bank Mt. Ayr, IA	8-10-84 18,843	5	7-27-84 5 7-8-83 4
50. American National Bank McLean, TX	8-16-84 14,420	5	7-31-83 4 8-7-81 2
51. Girod Trust Company San Juan, PR	8-16-84 412,018	5	6-10-83 4 9-30-82 3
52. The First State Bank Thayer, KS	8-22-84 12,396	5	10-11-83 4 6-9-82 3
53. Hereford State Bank Hereford, CO	8-24-84 2,690	5	6-22-84 5 9-17-82 4
54. Bank of the Northwest Eugene, OR	8-31-84 21,028	5	1-20-84 5 7-29-83 5
55. David City Bank David City, NE	9-6-84 21,398	5	2-24-84 5 12-10-82 3
56. Oakland Savings Bank Oakland, IA	9-7-84 21,647	5	3-2-84 4 9-12-83 3
57. Community Bank & Trust Company Enid, OK	9-14-84 30,966	5	7-20-84 5 11-4-23 4
58. Bank of Verdigre and Trust Company Verdigre, NE	9-19-84 13,226	5	6-27-84 5 10-18-82 2

1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING		
		AT CLOSING	LAST TWO EXAMINATIONS	
59. Century National Bank Jacksonville, FL	9-20-84 15,245	5	4-30-84 9-30-83	5 5
60. Security State Bank Weatherford, OK	9-21-84 54,675	5	4-2-84 7-11-83	5 5
61. The Farmers and Merchants Bank Tecumseh, OK	10-5-84 29,507	5	5-24-84 11-25-83	5 5
62. Orange Savings Bank Livingston, NJ	9-28-84 513,376	5	2-29-84 3-31-83	5 5
63. The Rexford State Bank Rexford, KS	10-10-84 5,807	5	8-24-84 6-14-82	5 2
64. Oneida Bank & Trust Company Oneida, TN	10-12-84 5,712	5	3-3-84 7-5-83	5 2
65. Bucklin State Bank of Bucklin, Missouri Bucklin, MO	10-12-84 14,388	5	3-9-84 2-19-82	4 2
66. American State Bank Thomas, OK	10-19-84 22,888	5	3-16-84 10-21-83	5 4
67. Farmers State Bank Kilgore, NE	10-24-84 6,005	5	9-7-84 2-24-84	5 4
68. Bank of Cody Cody, NE	10-24-84 10,900	5	8-31-84 3-16-84	5 4
69. State Bank of Boyd Boyd, MN	10-24-84 6,889	5	4-25-84 10-17-83	5 4

- 7 -

1984

NAME/LOCATION	DATE CLOSED \$ ASSETS	COMPOSITE CAMEL RATING		
		AT CLOSING	LAST TWO EXAMINATIONS	
70. The First National Bank of Gaylord Gaylord, KS	10-25-84 6,590	5	3-6-84 9-21-83	5 4
71. First American Banking Company Pendleton, OR	11-16-84 18,168	5	8-10-84 6-30-83	5 4
72. The Strong City State Bank Strong City, KS	11-29-84 4,584	5	9-12-84 5-24-82	5 2
73. The Dayton Bank & Trust Company Dayton, TN	11-30-84 49,109	5	2-27-84 5-9-83	5 5
74. Golden Spike State Bank Tremonton, UT	12-4-84 7,303	5	8-17-84 3-2-84	5 5
75. Farmers State Bank of Holyoke Holyoke, CO	12-7-84 4,121	5	7-13-84 3-9-84	5 5
76. University Bank of Wichita Wichita, KS	12-11-84 5,111	5	3-6-84 3-15-83	5 4
77. Uehling State Bank Uehling, NE	12-18-84 4,259	5	5-1-84 5-13-85	4 3
78. Farmers State Bank Selden, KS	12-20-84 14,642	5	6-30-83 8-3-81	3 2
79. First Security Bank Sandwich, IL	12-22-84 11,049	5	2-11-84 1-22-83	4 2

FDIC

Federal Deposit Insurance Corporation
Washington, D.C. 20429

Office of Congressional Relations and Corporate Communications

June 19, 1985

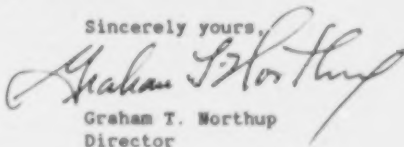
Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

Following Chairman Isaac's appearance before your Committee on May 8, 1985, Senator Riegle and Senator Sasser submitted additional questions for him to answer for the record.

Enclosed are the Chairman's responses to those questions. We have given copies of these responses to both Senators.

Sincerely yours,



Graham T. Worthup
Director

cc: Honorable Donald W. Riegle, Jr.
Honorable James R. Sasser

Answers to Questions Submitted by Senator Reigle to Chairman Isaac

Question: How, if at all, do you believe our financial regulatory agencies should be restructured?

Answer: The deposit insurance and supervisory framework can no longer afford merely to react to change. It must be structured and equipped to deal with the dynamics of the financial services industry of today and of the future. In 1983, the FDIC submitted to Congress a study entitled Deposit Insurance in a Changing Environment, which contained recommendations concerning the deposit insurance and supervisory framework. These recommendations are summarized below:

Merger of the Insurance Funds

An important step toward the rationalization of the regulatory system would involve the merger of the FDIC and the FSLIC. It is difficult to argue that the insurance funds of the FSLIC and the FDIC should be separately maintained when the functions of the thrift institutions and commercial banks are so similar that virtually the only distinction that can now be found in present law between the two types of institutions is in the nature of the insurance attached to the liabilities of each. Not only are the depository institutions involved now almost indistinguishable in the powers they possess, but they are also beginning to come together, in some instances, in larger financial organizations, a trend that doubtless will accelerate in the future.

The deposit insurance funds are similar in many respects. Possibly more important, the public interest objectives of deposit insurance are identical for the two funds, namely, to protect the nation against the destabilizing consequences of the failure of depository institutions, and to assure depositors, particularly those least able to sustain losses due to bank failure, that their deposits will be made immediately available.

For those who may desire, for one reason or another, to keep the funds separate, it is always possible to put together a group of technical arguments or to cite difficulties that will be encountered. However, once it is decided to consolidate, solutions are available to meet any difficulties.

The FDIC has recommended that the FSLIC be merged into the FDIC. It is more practical to consider utilizing the FDIC as the receiving agency since it already supervises an important body of thrift institutions (mutual savings banks). It insures approximately two-thirds of all federally insured deposits. It is an independent agency rather than simply one of the operating arms of a larger agency, as is the case with the FSLIC. It has by far the largest fund and administrative staff, and has the greatest name recognition.

The two deposit insurance funds could be administered separately, or joined. A phase-in program can be instituted to meet transitional problems, if any. Administration of the new agency could be by a board with representation designed to assure that any special interests of existing agencies are met.

Reorganization of the Federal Regulatory System

Reorganization of the federal regulatory system has been one of the largest running debates in Washington, surfacing almost immediately after the present structure was put into place in 1933. Moreover, whereas much of the debate in the past centered on simply combining those agencies dealing with banks, today there is no need to exclude from such proposals the Federal Home Loan Bank Board, which is chartering and supervising depository institutions with powers virtually identical to those of banks.

Under the approach recommended by the FDIC, the insurance agency would no longer be involved in the applications process or in any other regulatory matters affecting depository institutions except those that relate directly to safety and soundness considerations. Sole responsibility for the resolution of competitive factors in merger and acquisition cases would reside in the Attorney General's office, which is the principal enforcer of the antitrust laws, while the SEC would handle all securities matters and the Federal Trade Commission all consumer compliance matters.

The new insurance agency would have authority to require reports of, conduct examinations of, and take enforcement actions against, all its insured banks and thrifts and their affiliates. It would focus on problem and near-problem institutions, only sampling the sound institutions. Provision would be made for Federal Reserve Board representation on the insurance agency board; possibly, depending on the form of reorganization, the Federal Reserve could also be represented on the board of the consolidated regulatory agency.

A single agency should be established for chartering and regulating all federal banks and thrifts, and for regulating holding companies. At the same time, greater reliance should be placed on state supervisors for primary supervision and corporate applications from state-chartered depository institutions.

-3-4-

Question: What are your views on the recommendations made by Vice President Bush's Task Group on the Regulation of Financial Services?

Answer: We are enthusiastic about the Task Group's Report, titled Blueprint for Reform, as it relates to the FDIC and our strategic plans. It contains a number of proposals especially important to us:

- It clearly recognizes the FDIC's right and responsibility to examine any troubled FDIC-insured bank or thrift, irrespective of charter, and to sample nontroubled institutions, including affiliates. To the extent feasible, these exams would be coordinated with the primary supervisor.
- It would grant the FDIC the authority to take the full range of enforcement actions against any problem bank or thrift we insure.
- It would grant the FDIC authority, based on managerial or financial factors, to veto deposit insurance applications by new national or state member banks.
- It recommends granting to the FDIC the authority to implement risk-related deposit insurance premiums.
- It would relieve the FDIC of the burden of handling securities regulation, antitrust enforcement and routine branch applications by state nonmember banks.
- It would strengthen the FDIC's board by substituting a full-time, Presidentially-appointed voting member for the Comptroller of the Currency and adding a nonvoting representative from both the Federal Reserve and the proposed Federal Banking Agency.
- It would direct the FDIC and the FSLIC to phase in common capital and accounting standards for banks and thrifts.
- It recognizes and preserves the FDIC's right to require reports on the condition and activities of any insured institution and its affiliates.

There are some areas where we take issue with the Blueprint. If the FDIC had been solely responsible for drafting the Blueprint, we would have curtailed to a much greater degree the Federal Reserve's involvement in day-to-day supervision and regulation. We believe the current and even the proposed level of involvement is unnecessary, inefficient and unwise. We are particularly concerned about the role the Blueprint proposes for the Federal Reserve in the certification of state banking departments and in the determination of permissible activities for bank holding companies.

As indicated above, we also favor other major reforms. We would have recommended that the FDIC and the FSLIC be merged. Moreover, in our opinion the Federal Banking Agency should have been independent from Treasury and been governed by a board.

Despite the flaws that we perceive in it, we are enthusiastic about the Blueprint's recommendations for the FDIC and believe that in total it represents a significant improvement over the status quo.

Questions: Following up on Senator Sasser's questions regarding bank director liability: Is there any way to limit the liability of outside bank directors so as to encourage responsible, competent individuals to serve on the boards of problem banks?

Increasingly we hear that institutions and corporations throughout all sectors of the economy are having difficulty attracting top-flight directors because of their liability to lawsuits on a wide variety of fronts. Is this a problem with respect to financial depository institutions?

In today's climate why would a retired highly paid chief executive officer, or a person with a similar background, want to become a member of the board of a bank?

Answers: There is no question that a bank director's job is demanding, more so today than ever before. Failure of bank directors to adequately fulfill their responsibilities in establishing policy and supervising active management has been an important factor contributing to the many bank failures of recent years. As a result of increased bank failures, there has been an increase in suits of bank directors and officers by the FDIC and others.

An event which appeared to raise many questions about the cost and availability of coverage was Bank of America's suit against six of its employees and two of its insurance companies which had written directors' and officers' liability policies.

We have no hard facts addressing this question, but based upon our recent experience there does appear to be increased cost and reduced availability of liability coverage for directors and officers. However, apart from reduced availability, it appears that coverage sometimes excludes suits brought by the FDIC in connection with failed banks and/or suits by stockholders or others relating to mergers. These exclusions greatly reduce the value of indemnification policies.

It is unknown whether insurance or risk of liability is preventing qualified people from accepting positions as bank directors. Even if this were so, the FDIC would not favor reducing or eliminating this risk. It is extremely important that directors faithfully execute the duties of their offices. This performance is their best protection against lawsuits. If an individual is not willing or able to devote the time and effort necessary for satisfactory performance, the FDIC would prefer that he or she not accept a bank director position. In spite of the existing liability, inadequate director performance is a factor in virtually all problem banks.

The FDIC as receiver for failed banks has a legal responsibility and a policy to seek damages from officers and directors when circumstances warrant. In the case of each bank failure, FDIC personnel conducts an investigation relating to the causes of the failure and the potential liability of the bank's directors and officers. The FDIC does not bring suit against all directors and officers of failed banks, but only against those whose performance provides a basis for suit. The existence of a director and officer liability policy is not the determinative factor in a decision to bring suit.

Finally, it should be noted that a suit by the FDIC frequently is in lieu of a shareholder suit. Indeed, the FDIC's pending lawsuit against certain former officers and directors of Continental Illinois National Bank and Trust Company of Chicago had been commenced prior to the FDIC's permanent assistance transaction with Continental.

In spite of the increased problems associated with being a bank director, there are many positive aspects to the position. Selection as a bank director is regarded as an honor. It denotes an individual's reputation as being successful in their own affairs, public spirited, and entitled to public trust and confidence. The number of bank directors who are sued are a small percentage of the total population of bank directors. A competent individual, willing to extend a good faith effort in the performance of his duties, need have little fear of the liability associated with his position.

Answers to Questions Submitted by Senator Sasser to Chairman Isaac

Question: In the case of banks that have to be liquidated, what are the prime policies that the FDIC is taking to recoup funds that will minimize the drawdown on the FDIC Fund?

Answer: The FDIC has two primary methods of handling failed banks -- a deposit payoff or a purchase and assumption transaction. By law, the FDIC is only required to pay off the insured depositors up to the \$100,000 insured maximum. It is not required to arrange a purchase and assumption transaction but it may do so whenever in the judgment of the Board of Directors such action will reduce the risk or avert a threatened loss to the FDIC. Each failed or failing bank case is analyzed and studied carefully to determine if the "cost test" can be met before the FDIC's Board of Directors will approve a purchase and assumption transaction. In most cases, the Board can make the determination that such a transaction will reduce the potential loss to the FDIC because of the premium paid by the assuming bank.

Purchase and assumption transactions are structured so that in addition to acquiring the liabilities of the closed bank, the good quality assets of the closed bank must be purchased as part of the transaction. By structuring the transaction in this fashion, the initial cash outlay by FDIC is reduced.

In those situations where a purchase and assumption transaction cannot be arranged, the FDIC has developed Deposit Insurance Transfer Agreements whereby only the insured deposits up to the maximum of \$100,000 are transferred to a paying agent bank. This type of transaction has many of the attractive features of a purchase and assumption in that assets of the failed bank are sold to the paying agent bank and a premium is received, but it also protects the deposit insurance trust fund from unknown and/or contingent liabilities.

In addition, the FDIC's Division of Liquidation is committed to recovering disbursements by the FDIC as early as possible by realizing maximum collections on the assets it has acquired for liquidation.

Question: Could you provide for the Committee the number of bank directors currently under civil suit by the FDIC? Also, is it possible to provide for the Committee the average amount of legal costs that are now being incurred in pending suits, both for the FDIC and bank director defendants?

Answer: The FDIC maintains statistics relating to suits involving directors and officers according to the number of bank failures (or near failures), rather than by the number of directors and officers involved. There are currently 71 of these suits pending. As a general matter, suits against directors and officers normally involve between five and 25 defendants.

We cannot provide average fee expenditures for directors' and officers' liability cases, because in our experience the cost of these suits varies widely. During 1984, total outside legal fees and expenses of approximately \$1,853,000 were incurred in these matters. Through March 31 of this year, approximately \$2,001,000 has been expended for outside legal fees and expenses in these matters. These fees also relate to certain additional litigation concerning directors' liability claims, including: (1) insurance coverage litigation; (2) probate and bankruptcy litigation relating to deceased or insolvent directors; and (3) intervention in stockholder litigation where stockholders assert a claim which belongs to the FDIC or which may be subordinate to the FDIC's claim.

The FDIC's efforts in directors' and officers' liability cases led to recoveries in excess of \$12 million during 1984 and in excess of \$6.5 million through March 31, 1985. (Because of the extended nature of litigation, it should be noted that expenditures in one period do not correlate with recoveries for that period. For example, it is expected that a significant portion of the 1984 and 1985 expenditures described above will result in recoveries in the remainder of 1985, in 1986 and thereafter.) We believe these favorable results are attributable in significant part to the FDIC's methodology for handling these cases. A group of FDIC lawyers in Washington specializes in claims against directors and officers. After each bank failure, these lawyers supervise an investigation, conducted by FDIC examiners and liquidators, into the potential liability of directors and officers of the bank. The investigation precedes the filing of any lawsuit and is designed to insure that a suit is meritorious and likely to be cost effective. In addition, staff lawyers sometimes are able to avoid litigation by negotiating settlements of potential claims without involving, or only modestly involving, outside counsel.

The FDIC has no information relating to the legal fees paid by director defendants.

-3-

Question: Are any bank directors who are being sued in civil suit by the FDIC liable to recover legal fees under the provisions of 12 U.S.C. 1818(n) which states in part, "Any court having jurisdiction of any proceeding instituted under this section by an insured bank or a director or officer thereof, may allow to any such party such reasonable expenses and attorneys' fees as it deems just and proper; and such expenses and fees shall be paid from the bank or from its assets"?

Answer: The referenced provision, 12 U.S.C. 1818 (n), relates to administrative enforcement proceedings brought by the FDIC, such as cease and desist, termination of insurance, removal of directors or officers, and assessment of civil money penalty actions. The provision is not applicable to civil suits brought by the FDIC as receiver or liquidator of the assets of a failed bank.

Question: Do you believe there is sufficient indemnification insurance for bank directors who may face civil suit by the FDIC in the case of bank liquidation? Is bank director insurance becoming too expensive? Is it going the way of malpractice insurance?

Answer: There is no question that a bank director's job is demanding, more so today than ever before. Failure of bank directors to adequately fulfill their responsibilities in establishing policy and supervising active management has been an important factor contributing to the many bank failures of recent years. As a result of increased bank failures, there has been an increase in suits of bank directors and officers by the FDIC and others.

An event which appeared to raise many questions about the cost and availability of coverage was Bank of America's suit against six of its employees and two of its insurance companies which had written directors' and officers' liability policies.

We have no hard facts addressing this question, but based upon our recent experience there does appear to be increased cost and reduced availability of liability coverage for directors and officers. However, apart from reduced availability, it appears that coverage sometimes excludes suits brought by the FDIC in connection with failed banks and/or suits by stockholders or others relating to mergers. These exclusions greatly reduce the value of indemnification policies.

Question: Could you comment on your recent statements about forthcoming FDIC public disclosure policies for banks? Is it your contention that these disclosure policies are needed to bolster public confidence in the banking system in a deregulated environment? Will these future policies work to make current and future bank directors more aware of their financial and fiduciary responsibilities in maintaining a sound bank?

Answer: The FDIC has expressed repeatedly the desire to increase market discipline. In order for the market to make distinctions between poorly run and well run institutions, it needs information about institutions competing for its business. The FDIC believes the forthcoming public disclosure of enforcement actions will promote public understanding of, and confidence in, the banking system by providing significant and meaningful information regarding the condition and practices of banks. It is also believed that concern that a bank's difficulties, and by inference individual director's performance, will become known within the community should increase the director's awareness of the importance of fulfilling their financial and fiduciary responsibilities in maintaining a sound bank.

The CHAIRMAN. The committee will come to order.

I'd like to have at this time Joe Selby, Acting Comptroller of the Currency; Edgar Callahan, Chairman, National Credit Union Administration.

Gentlemen, we're happy to have you with us and I'm sorry for the interruption but we are trying to do something on the floor.

Before we turn to your testimony, I'd like to recognize the distinguished Senator from New York.

Senator D'AMATO. Thank you very much, Mr. Chairman.

Mr. Chairman, I have two other hearings that we're holding simultaneously with this one and so in the interest of time, I'm wondering if I might not be able to submit several questions for the record rather than intrude on the orderly progression of the witnesses.

The CHAIRMAN. Certainly, we'd be happy to do that.

Senator D'AMATO. Thank you very much, Mr. Chairman.

[Response to written questions of Senator D'Amato from Paul Volcker follow:]



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

June 4, 1985

PAUL A. VOLCKER
CHAIRMAN

The Honorable Alfonse D'Amato
Chairman, Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United State Senate
Washington, D.C. 20510

Dear Chairman D'Amato:

I am writing in response to a letter that I received from you on May 10, 1985, requesting amplification of my testimony on interstate banking as presented on May 8, 1985, to the Committee on Banking, Housing and Urban Affairs.

In my testimony before the Senate Committee and in similar testimony on April 24, 1985, before the Subcommittee on Financial Institutions, Supervision and Regulation of the House Committee on Banking, Finance and Urban Affairs, I stated the position of the Federal Reserve Board that Congress should promptly take action, as part of more comprehensive banking legislation, to authorize some interstate banking. While the ultimate objective of such legislation should be more general interstate banking, the Board recognizes the desirability of transitional arrangements, provided those transitional arrangements are of limited duration, avoid undue concentration of banking resources, maintain a climate in which small institutions can flourish and permit an important role for the individual state in defining its intrastate banking structure.

Your first question concerns how soon after state enactment of a limited interstate banking statute should participation in fuller interstate banking be "triggered." The Board recommends a trigger to national reciprocal interstate banking (of the type currently permitted by the State of New York) for any state that chooses to allow some form of limited regional interstate banking. This transition to national reciprocal interstate banking should be triggered after a minimal period which would avoid undue delay that could cause substantial injury to excluded competitors and more general damage to the banking system as a result of Balkanization of banking into regional concentrations. In balancing these considerations the Board has concluded that five years appears

to be too long a period to permit limited interstate banking on a discriminatory basis before triggering interstate banking on a national reciprocal basis. On the other hand, a period of one year appears too short to permit regional experimentation. Accordingly, the Board has suggested a three year trigger provision.

I should note that in my testimony I recommended that regional banking was only one of a possible series of transitional interstate banking steps that might be authorized by Congress. In conjunction with regional banking Congress should permit bank holding companies with a subsidiary bank in one of the 35 Metropolitan Statistical Areas ("MSAs") or Consolidated Metropolitan Statistical Areas ("CMSAs") that extend across state lines to acquire additional banks within the MSA or CMSA. Similarly, Congress should authorize bank holding companies with subsidiary banks in counties that border on another state to acquire banks in the contiguous county of the other state. In both cases, such limited interstate acquisitions should be authorized to commence immediately and not at some future trigger date.

Your second question concerns the restrictions the Board has suggested to limit the concentration of banking resources in any state or region and in the nation as a whole. The Board has suggested these limitations for a variety of reasons. Such concentration limits are intended to preserve the diversity of banking resources that is almost unique to the United States. In preserving such diversity, concentration limits will help to maintain effective competition by a multiplicity of financial institutions that will be responsive to the credit and service needs of local communities. Such limits will also help to avoid the inherent risks of adverse economic consequences that may result from the excessive concentration of credit resources in a few dominant institutions.

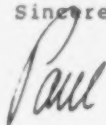
The Board has suggested four interrelated limits or restrictions on interstate acquisitions by bank holding companies:

- (1) An absolute prohibition against the largest 25 banking organizations, in terms of domestic banking assets, acquiring one another.
- (2) A limit on the percent of total banking assets in depository institutions that a particular banking organization may hold as a result of an acquisition, other than a de novo or small "foothold" acquisition.

- (3) A prohibition on any acquisition that would increase the concentration of assets or deposits in one state held by a single banking organization beyond the limit set by that state by statute.
- (4) A prohibition on any acquisition that results in an undue concentration of resources in the United States or any region of the United States or in any state.

My staff has drafted legislation which would implement these concepts. I am enclosing a copy for your review.

Sincerely,

A handwritten signature in cursive script, appearing to read "Paul".

Definitions

Sec. __. Section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841), is amended by adding the following new subsection (j):

"(j) For purposes of section 3 of this Act--

"(1) a bank holding company is located in that State in which its banking subsidiaries principally conducted their operations on July 1, 1966, or the date such company became a bank holding company, whichever is later, and is an 'out-of-state bank holding company' with respect to all other States;

"(2) 'banking organization' means a bank holding company or a bank;

"(3) 'domestic deposits' means the total consolidated deposits of a depository institution (other than deposits of other depository institutions) (A) as reported in its report of condition or equivalent report as determined by the Board that are held at locations in the United States or (B) at any location outside of the United States that the Board determines, in a particular case or by rule for all depository institutions, should be included as domestic deposits in order to prevent evasion of section 3(c)(2) of this Act;

"(4) depository institution means any institution, the deposits of which are federally insured, any branch or agency of a foreign bank in the United States, and

any corporation organized or operating under section 25 or 25(a) of the Federal Reserve Act;

"(5) 'depository institution holding company' means any company that controls a depository institution;

"(6) 'report of condition date' means the date insured banks are required to file reports of condition with the Federal Deposit Insurance Corporation pursuant to section 7(a) of the Federal Deposit Insurance Act (12 U.S.C. 1817(a)); and

"(7) 'State' shall include the District of Columbia."

Provisions for a Transition to
Limited Interstate Banking

Sec. ____ Section 3(d) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(d)), is amended --

(1) by redesignating section 3(d) as section 3(d)(1); and

(2) by adding the following new paragraphs:

"(2)(A) A State that, pursuant to this subsection, authorizes the acquisition of banks located in that State by out-of-state bank holding companies may limit such authorization to out-of-state bank holding companies that are located in:

"(i) a specifically designated State or specifically designated States; or

"(ii) any State that has enacted a statute providing for the reciprocal treatment of acquisitions of banks located in such State by bank holding companies located in the authorizing State.

"(B) A State may limit acquisition of banks located in that State by out-of-state bank holding companies based upon the financial condition of the bank to be acquired or the number of years such bank has been in existence.

"(3) Notwithstanding any other provision of this subsection, the Board shall not approve any application by a bank holding company to acquire a bank located outside of the State in which such bank holding company is located pursuant to

a State statute that limits acquisitions of banks in that State to out-of-state bank holding companies located in a designated State or designated States, pursuant to clause (i) of paragraph (2)(A) unless such State statute authorizes, within three years after its effective date, the acquisition of banks in such State by bank holding companies located in any State that has in effect a statute authorizing the acquisition of banks in that State by any out-of-state bank holding company without limitation or on a reciprocal basis as permitted by clause (ii) of paragraph (2)(A).

"(4) A bank holding company that, after [the date of introduction of this legislation], acquired control of a bank pursuant to a State statute that (A) limits acquisitions of banks in such State to out-of-state bank holding companies located in a designated State or designated States pursuant to clause (i) of paragraph (2)(A), and (B) does not authorize, within three years of the date of enactment of [this legislation], acquisitions of banks in that State by out-of-state bank holding companies without limitation or on a reciprocal basis as permitted by clause (ii) of paragraph (2)(A), shall not retain control of such bank after three years from the date of enactment of [this legislation].

"(5) Nothing in this subsection shall limit the authority of a State to require that out-of-state bank holding companies that control banks within the State comply with

reporting, examination, and other requirements applicable to bank holding companies located within the State, provided such requirements apply equally to all bank holding companies located within the State and are not enacted for the purpose of excluding any class of out-of-state bank holding companies from acquiring banks located in the State."

Sec. __. Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding at the end thereof the following new subsection:

"(m) No insured bank shall establish or maintain branches (as defined in 12 U.S.C. 36(f)) outside the State, including the District of Columbia, in which the insured bank is chartered and maintains the largest number of its branches, unless such branch was established before the date of enactment of [this legislation]."

Provisions for Immediate Limited Interstate
Banking in Adjoining Metropolitan and Other Areas

Sec. __. Section 3(d) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(d)), is amended by adding the following new paragraph:

"(6)(A) Notwithstanding paragraph (1) of this subsection or any provision of State law that would prohibit the acquisition of a bank in such State by an out-of-state bank holding company, a bank holding company may acquire--

"(i) a bank that:

(I) is located in a Metropolitan Statistical Area ("MSA") or consolidated Metropolitan Statistical Area ("CMSA"), as defined by the Office of Management and Budget, in which a subsidiary bank of the applicant bank holding company is located or operates a branch; and

(II) does not maintain a branch or deposit taking office outside of that MSA or CMSA; or

"(ii) a bank that:

(I) is located in a county, or equivalent local governmental unit as determined by the Board, outside of the State in which the bank holding company is located, if such county or equivalent governmental unit is contiguous to the State in which the bank holding company is located and to a county or equivalent local governmental unit, as the case may be, in that State in which a subsidiary bank of

the bank holding company is located or operates a branch or deposit taking office; and

(II) does not maintain a branch or deposit taking office outside of that county or equivalent local governmental unit.

"(B) Notwithstanding any other provision of law, a bank (or any successor thereto) acquired by an out-of-state bank holding company pursuant to this paragraph shall not by merger, acquisition, or in any other manner establish or operate a branch or other deposit taking office outside of such MSA or CMSA or county or equivalent local governmental unit, as the case may be, after its acquisition by such out-of-state bank holding company, unless such bank holding company is otherwise permitted by State statute to acquire banks in such State.

Undue Concentration of Resources Standards

Sec. ____ . Sec. 3. Section 3(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1842(c)), is amended

--

(1) by redesignating section 3(c) as section 3(c)(1); and

(2) by adding the following new paragraphs:

"(2) Except as provided in paragraph (3), the Board shall not approve any application under this section if --

"(A) consummation of the proposal is likely, in the Board's judgment, to lead to an undue concentration of resources in the provision of banking services in the United States or in any State or region of the United States;

(B) the applicant bank holding company and the banking organization to be acquired are as of the latest report of condition date, or were on ten of the twelve report of condition dates during the three-year period preceding the date the application was filed, among the twenty-five (25) largest banking organizations in the United States in terms of total domestic deposits;

(C) the applicant bank holding company will, upon consummation of the proposal, control more than 2.5 percent of the total domestic deposits in depository institutions as of the latest report of condition date, or as of any of the eight preceding report of condition dates, unless

the bank to be acquired is a newly chartered bank or a bank that has total assets of less than \$100 million; or

(D) consummation of the proposal would increase the percentage of the total assets or deposits in all banks or depository institutions in the State in which the bank to be acquired is located that may be held or controlled by a single banking organization or depository institution holding company, together with its affiliates, beyond a limit established by such State by statute, provided such statute applies equally to all such organizations or holding companies, as the case may be, located within the State.

"(3) Paragraph (2) of this subsection shall not apply if the Comptroller of the Currency or the State bank supervisory authority, as the case may be, certifies to the Board that consummation of the proposal described in the application is necessary in order to prevent the probable failure of the bank to be acquired or to permit the bank (or a successor) to resume operations after it has failed."

Sec. ____ . Section 18(c)(5) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)(5)) is amended --

(1) by redesignating section 18(c)(5) as section 18(c)(5)(A); and

(2) by adding the following new clauses:

"(B) The responsible agency shall not approve any application under this subsection if --

(i) consummation of the proposal is likely, in the judgment of the responsible agency, to lead to an undue concentration of resources in the provision of banking services in the United States or in any State or region of the United States;

(ii) the banks involved, or bank holding companies that control such banks, are as of the latest report of condition date, or were on ten of the twelve report of condition dates during the three-year period preceding the date the application was filed, among the twenty-five (25) largest banking organizations in the United States in terms of total domestic deposits;

(iii) the resulting bank, or a bank holding company that controls such bank, will, upon consummation of the proposal, control more than 2.5 percent of the total domestic deposits in depository institutions as of the latest report of condition date, or as of any of the eight preceding report of condition dates, unless the bank to be acquired by merger, consolidation or through the acquisition of its assets and assumption of its liabilities is a newly chartered bank or a bank that has total domestic deposits of less than \$100 million; or

(iv) consummation of the proposal would increase the percentage of the total assets or deposits in all

banks or depository institutions in the State in which the resulting bank is located that may be held or controlled by a single banking organization or depository institution holding company, together with its affiliates, beyond a limit established by such State by statute,¹ provided such statute applies equally to all such organizations or holding companies, as the case may be, located within the State;

"(C) Clause (B) of this paragraph shall not apply if the Comptroller of the Currency or the State bank supervisory authority, as the case may be, certifies to the responsible agency that consummation of the proposal described in the application is necessary in order to prevent the probable failure of one of the banks involved or to permit the bank (or a successor) to resume operations after it has failed.

"(D) The terms "banking organization," "depository institution," "depository institution holding company," "report of condition date," and "domestic deposits" have the same meanings as provided in section 2(j) of the Bank Holding Company Act (12 U.S.C. 1841(j))."

Insert after the semicolon on line 19, page 16 the word "and" and the following clause (iii):

"(iii) Investments of the type described in clause (i)(IV) hereof and cash shall constitute related investments for an insured or uninsured institution only in the amount required to be maintained as liquid assets for an insured institution pursuant to section 5A of the Federal Home Loan Bank Act."

The CHAIRMAN. Mr. Selby, we're happy to welcome you before the committee.

Would you please proceed?

STATEMENT OF H. JOE SELBY, ACTING COMPTROLLER OF THE CURRENCY

Mr. SELBY. If I might, I'll ask that the full statement we submitted be placed in the record, and I will summarize that statement.

The CHAIRMAN. We will place your entire statement in the record, both of you.

SUPPORT EXPANSION OF POWERS

Mr. SELBY. Mr. Chairman, members of the committee, I am pleased to be here today to express my support for legislation that would allow banks greater flexibility in meeting market demands. It's has long been the position of our office that new product powers and the removal of restrictions on geographic expansion will strengthen the banking system.

In 1980, Congress enacted the Depository Institutions Deregulation Act which provided for the removal of interest rate ceilings on liabilities. However, it did nothing to relieve banks of product and geographic restrictions.

While the Garn-St Germain Act of 1982 provided for some expansion of thrift powers, it contained no significant bank deregulation. In light of congressional inaction, Federal regulatory agencies and some State legislatures have taken steps to enhance banks' ability to compete.

Despite these limited exceptions, the legal structure governing the banking industry has remained basically unchanged for decades. Yet, the need for statutory reform has become even more pressing.

Banks continue to face competition from less regulated providers. Consumers are becoming more discriminating about the quality and variety of financial services, and less concerned about whether or not their provider is a bank.

Banks are now paying market rates for virtually all deposits, but still cannot expand product lines or diversify geographically. Meanwhile, asset quality has continued to deteriorate as certain sectors of the economy make adjustments to the significantly lower inflation rates of the last few years.

The most disturbing aspect of the continued failure to legislate substantive deregulation is that large segments of the financial services industry have been the primary opponents of change. Some bankers oppose the removal of restrictions on entry into their geographic markets. Those in the securities, insurance, and real estate businesses oppose the removal of restrictions that, in effect, protect them from competition.

These providers would not fear the competition if they did not anticipate that the new entrants would provide services that customers might find more attractive. To allow this situation to continue means denying consumers the benefits of broader choices and competitive products.

Laws that segment the market for financial products need to be changed. Banks or their holding companies should be permitted to offer a wider range of financial services including insurance, real estate brokerage, and securities services.

Geographic expansion should also be addressed by Congress. Interstate banking is a reality for many purchasers of banking services. Current restrictions only deny the benefits of increased competition to consumers and smaller businesses. We believe that Congress should enact legislation that provides a framework for the transition to full interstate banking.

Reform of the deposit insurance system is necessary in order to subject financial institutions to greater market discipline.

Resolution of the questions of expanded product powers, geographic expansion and deposit insurance reform logically lead directly to rationalization of the financial regulatory system. The report of the Bush task group represents a first step toward such functional regulation.

Expansion of banks' powers must be accompanied by strengthened supervision. Banks and the public should understand that deregulation does not mean no regulation. Rather, it means that as institutions gain more autonomy in decisionmaking, they will have to be responsible and accountable for those decisions. When increased risks are taken, safeguards against those risks must be imposed. The OCC's recently adopted capital requirements and our ongoing enforcement actions for violations of law and imprudent bank practices are directed to that objective.

The Congress, the regulators, and the banking industry all have faced important challenges in this decade. Many steps have been taken by all three to meet these challenges. However, much more progress is needed, and I think the next step is in the hands of the Congress.

Thank you.

[The complete prepared statement follows:]

Statement of

H. JOE SELBY

ACTING COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

May 8, 1985

Mr. Chairman, members of the Committee, I am pleased to be here today to express my support for legislation that would allow banks greater flexibility in meeting market demands. I will first discuss the forces that have come together in this decade to create a significant need for change in the legal structure governing depository institutions. Then I will review the limited progress to date in accomplishing this change. Finally, I will discuss what remains to be done in order to ensure that the banking system remains strong, viable, and responsive to the marketplace.

THE NEED FOR DEREGULATION IN THE 1980s

For almost fifty years, banks have operated with price, product, and geographic restrictions. These restrictions, though essentially anti-competitive, were designed to insulate institutions from failure. They ensured that markets were protected from outside competition and that deposit costs were kept down.

This system worked fairly well for many years. In the 1970s, however, the marketplace began to change dramatically. Soaring inflation and high and volatile interest rates resulted in demands for a host of new services and financial instruments. Banks, hamstrung by restrictions, were prevented from responding promptly and effectively to these demands. Less restricted providers, armed with new technological capabilities, moved quickly to fill the void. In particular, money market mutual funds grew at an incredibly rapid rate.

As a result of these developments, banks faced increasing funding costs, and many faced eroding market shares. Some banks found innovative, though circuitous ways to meet their customers' demands for higher yields. Many banks simply lost depositors to money market mutual funds and other competitors and had to replace the funds at market rates.

As the 1980s arrived and banks were grappling with these competitive pressures, deteriorating economic conditions caused a decline in asset quality. Banks found themselves unable to maintain the profitability of their traditional product lines yet restricted from moving into new product lines. It became more important than ever that they be given a chance to compete in the financial services marketplace on an equal basis.

PROGRESS TO DATE

Congress recognized these pressures in 1980 and enacted the Depository Institutions Deregulation Act, which provided for the removal of interest rate ceilings on liabilities. This was an important and needed action because it ultimately enabled banks to offer directly competitive deposit instruments. However, it did nothing to relieve banks of product and geographic restrictions. Nor in the five years that followed has Congress been successful in providing banks with new competitive freedoms despite the efforts that you, Mr. Chairman, and other members of this Committee have made towards this goal.

While the Garn-St Germain Act of 1982 provided for some expansion of thrift powers -- primarily by providing opportunities for diversification of their loan portfolios -- it contained no significant bank deregulation. Federal regulatory

agencies, and some state legislatures, however, moved into the vacuum created by Congressional inaction.

The OCC authorized national banks to offer a number of new services including discount brokerage and investment advisory services, common trust funds for the collective investment of IRAs, and underwriting credit life insurance. Also, bank customers can now obtain insurance products from agents who lease space on the bank's premises. We believe that such gross percentage leasing arrangements could be used to make other services, such as real estate brokerage, directly available to bank customers.

The OCC also gave banks greater flexibility to structure their loan products, including more liberal adjustable-rate mortgage lending authority. Barriers to entry into the banking system were reduced through a streamlining of our chartering procedures. The approval of nonbank banks expanded the geographic reach of bank holding companies.

Other federal regulators also took actions. The FDIC recognized the authority of nonmember banks to engage in a full range of securities activities. The NCUA, acting in accordance with its broad authority to determine the powers of credit unions, removed deposit rate ceilings at a much more rapid pace

than the DIDC. It has also authorized a number of new powers, including general insurance agency activities and discount brokerage.

The states have also been active in expanding the powers of banks. California, for example, permits state-chartered banks to invest in corporate securities, operate mutual funds, and develop real estate. New York similarly grants real estate acquisition and development powers to state-chartered banks. In addition, at least 19 states have enacted laws authorizing some form of regional interstate banking.

FURTHER CHANGE IS NEEDED

Despite these limited exceptions, the legal structure governing the banking industry has remained basically unchanged for decades. Yet, the need for statutory reform has become even more pressing.

Banks continue to face competition from less regulated providers. Consumers are becoming more discriminating about the quality and variety of financial services, and less concerned about whether or not their provider is a bank.

Banks are now paying market rates for virtually all deposits, but still cannot expand product lines or diversify geographically. Meanwhile, asset quality has continued to deteriorate as certain sectors of the economy make adjustments to the significantly lower inflation rates of the last few years.

The most disturbing aspect of the continued failure to legislate substantive deregulation is that large segments of the financial services industry have been the primary opponents of change. Although concerns have been raised about conflicts of interest and concentrations of economic power, the reality is that many financial service providers are benefitting from the existing competitive restraints.

Some bankers oppose the removal of restrictions on entry into their geographic markets. Those in the securities, insurance, and real estate businesses oppose the removal of restrictions that protect them from competition. These providers would not fear the competition if they did not anticipate that the new entrants would provide services that customers found more attractive. To allow this situation to continue means denying consumers the benefits of broad choices and competitive products.

Laws that segment the market for financial products need to be changed. The choice is really quite simple: either attempt

to require specialization by providers -- a course that has led inevitably to the growth of unregulated providers and attempts to exploit loopholes in current laws -- or grant regulated institutions additional powers that will enable households and businesses to enjoy the benefits of a more competitive marketplace. The OCC has long advocated the latter course. The OCC believes that banks or their holding companies should be permitted to offer a wider range of financial services including insurance, real estate brokerage, and securities services.

Geographic expansion should also be addressed by Congress. Interstate banking is a reality for many purchasers of banking services. Current restrictions only deny the benefits of increased competition to consumers and smaller businesses. We believe that Congress should enact legislation that provides a framework for the transition to full interstate banking. In our view a bill that permits regional compacts as a first step, and contains a trigger date not longer than five years after enactment would be appropriate.

In our view it is vital that such legislation leave the avenue that each financial institution takes towards regional, and then national, expansion up to the financial institution itself. It should be able to choose freely between interstate expansion by branching at the bank level, or by the creation or

acquisition of new subsidiaries by the holding company. Maximizing the number of avenues for interstate expansion will enable many financial institutions, including independent banks, to enjoy considerable cost savings and thus provide a more competitive market. It will also avoid an unintended bias in favor of the bank holding company form of banking structure.

Reform of the deposit insurance system is necessary in order to subject financial institutions to greater market discipline. First, an insurance pricing scheme that recognizes differences in risk assumed by insured institutions must be developed. Second, we need to remove any market perception that bank size alone -- regardless of the riskiness of the bank's activities -- conveys a degree of depositor protection. The FDIC recently requested comment on explicitly limiting the protection afforded depositors at failed banks by use of modified payout procedures. Such a step is worthy of close study.

In addition, the OCC feels that careful consideration should be given to the merger of the deposit insurance funds. We believe that such a merger would be appropriate after discrepancies in powers and regulatory treatment -- especially capital requirements and accounting practices -- of banks and thrifts are eliminated.

Expanded product powers, relaxation of geographic restrictions, and deposit insurance reform are critical to the continued viability of banks within the financial services industry. Resolution of those questions logically leads directly to rationalization of the financial regulatory system. Overlap and duplication of regulatory responsibilities should be eliminated and institutions that engage in similar activities should answer to the same regulator. The report of the Bush Task Group represents a first step toward such functional regulation.

Expansion of banks' powers must be accompanied by strengthened supervision. Banks and the public should understand that deregulation does not mean no regulation. Rather, it means that as institutions gain more autonomy in decision-making, they will have to be responsible for those decisions. When increased risks are taken, safeguards against those risks must be imposed.

The OCC has recently taken a number of steps to accomplish that objective. For example, we are preparing new disclosure guidelines that will help make management more accountable to the market. The International Lending Act of 1983 for the first time gave us the authority to prescribe and enforce capital ratios. Our capital regulations requiring national banks to have a ratio of primary capital to assets of at least 5.5 percent took effect last month. We are not, however, satisfied with the simple

capital ratio approach just adopted. We are studying an approach to capital adequacy that would encompass the total risk in the bank, including off-balance sheet activity. Under such an approach, banks could not sacrifice liquidity or sell relatively low-risk assets in response to binding capital requirements.

Additionally, we have been emphasizing strict enforcement action for violations of law and imprudent banking practices. In 1984 we took administrative actions against banks 398 times as compared to 133 times in 1981. We assessed civil money penalties 109 times in 1984 as compared to 19 times in 1981.

CONCLUSION

The Congress, the regulators, and the banking industry all have faced important challenges in this decade. Many steps have been taken by all three to meet these challenges. However, much more progress is needed. The next step is in the hands of the Congress.

The CHAIRMAN. Thank you, Mr. Selby.
Mr. Callahan.

**EDGAR F. CALLAHAN, CHAIRMAN, NATIONAL CREDIT UNION
ADMINISTRATION BOARD**

Mr. CALLAHAN. Mr. Chairman, members of the committee.

Thank you for inviting me before you today to review the present condition of our Nation's credit unions.

Inasmuch as my resignation was effective last Friday, I'm not appearing today as NCUA Board Chairman. I'm grateful to the committee for affording me the opportunity as a private citizen to give my thoughts based upon my service at NCUA.

I'm also pleased to be here because it gives me the opportunity to thank this panel, its staff, and especially Chairman Garn, for your counsel and support over the past 4 years.

It has been a privilege and a pleasure to work with you on behalf of NCUA and this country's 15,300 Federal and federally insured credit unions.

Turning to the business at hand, Mr. Chairman, 1984 and the first quarter of 1985, was a period of extraordinary good news for credit unions and credit union members. We witnessed a 5.1-percent increase in credit union membership to over 50 million people in 1984, double previous years rates.

More than 100 new charters adding a potential of 1.5 million members were approved by the agency. Another 2.7 million persons became eligible for credit union membership through field membership amendments.

In 1984, credit union shares rose by 16.1 percent to \$57.9 billion; loans by 26.9 percent to \$42 billion; and all reserves by 22.2 percent to \$4 billion.

The number of credit unions reporting operating losses for 1984 was only 1,041, or 9.9 percent and losses totaled only \$18.5 million. In 1980, the comparable figures were 3,950 credit unions experiencing losses of \$120 million. The number of problem credit unions, early warning system code 4 and 5's, declined by 22 percent from 1,024 at yearend 1983 to 872 at yearend 1984.

CONTINUED GROWTH FOR CREDIT UNIONS

Statistics for the first quarter of this year indicate continued growth for credit unions. On an annual basis, savings are up 17 percent; assets 17.4 percent; and loans 22 percent.

Finally, the number of problem code Federal and federally insured credit unions is down to 692, 21 percent less than in September of 1984.

I have been asked on many occasions to explain the reasons behind the extraordinary credit union growth story. I reply that credit unions were born in adversity, they sprang up during the depression, they flourished during the war years, and they have adapted remarkably to every set of economic circumstances since.

When given supervisory support instead of burdensome overregulation, they return to what they do best, providing basic financial services to their members on the most convenient and cost-effective terms possible.

On January 21 of this year, the share insurance fund received \$843 million from insured credit unions as a deposit in their fund. This development quadrupled the size of the fund; was the direct result of Congress' action last year in passing Public Law 98-369.

I would like to publicly and personally thank you, Mr. Chairman, for your crucial support in achieving this significant proposal.

Credit unions also deserve a great deal of praise for their foresight in supporting this self-help plan for their fund. They have raised the credit union insurance fund from the least well-reserved of the Federal deposit insurance funds to the best reserved.

Turning to legislation, Mr. Chairman, I understand that you will soon reintroduce comprehensive financial institutions reform legislation. I want to reiterate my support for the amendments to the Federal Credit Union Act contained in your bill S. 2851 of the last Congress. I want to stress my concern for two amendments in particular.

First, the amendment to eliminate the Federal credit union loan rate ceiling, the only Federal usury ceiling, is important to complement widespread deregulation of other restrictions on credit union freedom to operate.

Second, as you are aware, NCUA's conservatorship authority was granted on a temporary 3-year basis by the Garn-St Germain Act of 1982. Conservatorship has proven to be a most effective tool for the NCUA Board in better ensuring the safety and soundness of credit unions.

Since the conservatorship authority was granted, it has been used in seven cases involving assets of over \$278 million. Overall, we believe NCUA achieved over \$30 million in savings in the conservatorship cases handled thus far.

Mr. Chairman, NCUA's conservatorship authority is due to expire October 15. I believe this vitally needed tool should be made permanent by the Congress.

In conclusion, I want to stress that the greatest danger to credit unions is the tendency to see them and to treat them like any financial institution. Surely, through their financial performance in recent times, credit unions have proven themselves different in the strength of their insurance fund and in the matter they have chosen to strengthen it, they are different. But the most significant difference is the credit union philosophy and tradition of service, service through nonprofit member-oriented and member-operated cooperatives.

I firmly believe that if credit union regulators, legislators, and credit unions themselves, can recognize these unique characteristics, credit unions will continue to grow, prosper, and provide quality service for their millions of members.

Thank you. I'll be pleased to respond to any questions.

[The complete prepared statement follows:]

TESTIMONY OF
EDGAR F. CALLAHAN

CHAIRMAN

NATIONAL CREDIT UNION ADMINISTRATION BOARD

Mr. Chairman and members of the Committee, thank you for inviting me before you today to review the present condition of our nation's credit unions.

Inasmuch as my resignation will be effective Friday, this is my last opportunity to appear as NCUA Board Chairman before the Senate Banking Committee. I would be remiss, therefore, if I did not thank this panel, its staff, and especially Chairman Garn for your counsel and support over the past four years. It has been a privilege and pleasure to work with you in behalf of NCUA and this country's 15,300 Federal and federally-insured credit unions.

Turning to the business at hand, Mr. Chairman, 1984 and the first quarter of 1985 has been a period of extraordinary good news for credit unions and credit union members. With the celebration of the 50th Anniversary of the Federal Credit Union Act, we witnessed a 5.1% increase in credit union membership to over 50 million in 1984 -- double the previous year's rate. More than 100 new charters, adding a potential of 1.5 million members, were approved by the Agency. Another 2.7 million persons became eligible for credit union membership through field of membership amendments. I am most proud, Mr. Chairman, of the results of deregulation in this particular area. Our Agency has returned to credit unions themselves the right and responsibility to determine whom they will serve.

In 1984, credit union shares rose by 16.1% to \$57.9 billion, loans by 26.9% to \$42.1 billion, and all reserves by 22.2% to \$4 billion. These figures are outstanding in themselves but two factors make them even more remarkable.

First, this was the third consecutive year of outstanding growth. It is not uncommon to see a business or industry have one or two excellent years, but the last three years have seen year-to-year growth in shares of 17.3%, 20.7% and now 16.1% for a total of 54.1%. That is incredible. And it has been accomplished in an extremely competitive environment.

Second, the numbers in 1984 show remarkable balance. It is not unusual for one part of an operation to have a good year, such as shares, or loans or capital, but to have all three show positive results is a major accomplishment by the managers and directors of credit unions.

Credit unions in 1984 paid out a higher percentage of gross income to members in dividends than the year before -- 59.2% compared to 58.9%. Overall dividends went up 23.3% to over \$4.4 billion. We calculate the average return on shares was 8.2% in 1984 compared to 7.8% in 1983.

The number of credit unions reporting operating losses for 1984 was only 1,041 or 9.9% and losses totaled only \$18.5 million. In 1980, the comparable figures were 3,950 credit unions experiencing losses of \$120 million. The number of "problem" credit unions (Early Warning System Codes 4 and 5) declined by 22% from 1,124 at year-end fiscal '83 to 872 at year-end fiscal '84.

Statistics for the first quarter of this year indicate continued growth for credit unions. On an annual basis, savings are up 17.0%, assets 17.4%, and loans 22.2%. Finally, the number of problem code Federal and federally-insured credit unions is down to 692, 21% less than September 1984.

I have been asked on many occasions to explain the reasons behind the extraordinary credit union growth story. I reply that credit unions were born in adversity; they sprang up during the depression; they flourished during World War II; and they have adapted remarkably to every set of economic circumstances since. When given supervisory support, instead of burdensome overregulation, they return to what they do best: providing basic financial services to their members on the most convenient and cost-effective terms possible. The only threat to credit unions is the bureaucratic tendency to treat them, for convenience sake, the same as banks and savings and loans. This is a mistake, for they are made of a different fabric. It is a fabric woven tightly by thousands of volunteers, sponsoring companies, credit union organizations and NCUA -- all working together.

Share Insurance Fund

On January 2 of this year, the NCUSIF received \$843 million from insured credit unions as a deposit in their fund. This development, quadrupling the size of our fund, was the direct result of Congress' action last year in passing Title VIII of Public Law 98-369. I would like to publicly and personally thank you, Mr. Chairman, for your crucial support in achieving this significant proposal.

This new statute provides for strengthening of the NCUSIF through the placement of a deposit into the Fund by each insured credit union.

Credit unions, I believe, deserve a great deal of praise for their foresight in supporting this "self help" plan for their fund. They have raised the NCUSIF from the least well reserved of the Federal deposit insurance funds to the best reserved. Our ratio of equity to insured shares now is 1.27, up from .31 at year-end 1984.

Finally, we are very proud that, in a first for a Federal deposit insurance fund, the NCUSIF has received an unqualified, or "clean" opinion on its 1984 financial statements from a Big Eight accounting firm -- Ernst & Whinney, the Fund's outside auditor.

A clean opinion means that in Ernst & Whinney's judgment the NCUSIF's financial statements, taken as a whole, are presented fairly and in accordance with generally accepted accounting principles. This includes the establishment of adequate reserves to cover all losses which the Fund might reasonably be expected to experience from the problem credit unions it currently insures.

Legislation

Mr. Chairman, I understand that you will soon reintroduce comprehensive financial institutions reform legislation. I want to reiterate my support for the amendments to the Federal Credit Union Act contained in your bill (S. 2851) of the last Congress. I want to stress the need for two amendments in particular.

First, the amendment to eliminate the Federal credit union loan rate ceiling, the only Federal usury ceiling, is important to complement widespread deregulation of other restrictions on credit union freedom to operate. Each credit union's board of directors ought to set its own loan rates for its own members. Parenthetically, I should note that, with the present 21% ceiling in effect all year, credit union automobile loan rates averaged 13.31% in 1984, lower than the other major consumer lenders.

Second, as you are aware, NCUA's conservatorship authority was granted, on a temporary three-year basis, by the Garn-St Germain Act of 1982. Conservatorship has proven to be a most effective tool for the NCUA Board in better ensuring the safety and soundness of credit unions. It permits us to assume control of an institution, with no interruption in service to members, until the credit union can get back on its own feet. It also prevents a dissipation of assets that could have a substantial adverse effect on that credit union's members, creditors, and the NCUSIF.

The conservatorship option is also a valuable tool in the case of federally insured state chartered credit unions where the NCUA Board's ability to act is somewhat restricted, even though there is a consensus with the state authority that immediate action is necessary. Normally, the NCUA Board must wait for a state agency to place a credit union into liquidation and several months may elapse due to state procedural requirements. At that point, the NCUA Board accepts appointment as liquidating agent. During this period of time, it is the Share Insurance Fund which

is at risk, not the state authority, but the state authority is unable to expedite the matter. The NCUA Board would have no course of action to pursue to protect its interests because other forms of administrative actions do not provide for the controlling of credit union operations, as is the case in a conservatorship, and state procedural requirements on the state authority permit dissipation of assets.

Conservatorship has other benefits. In some cases, obtaining control of a credit union's operations and assets has precluded its officials, suspected of self-dealing and other questionable activities, from tampering with or destroying records of their activities, thereby preserving evidence where criminal activity was suspected.

It is also beneficial where the true causes of a credit union's problems, and thus the appropriate remedy, are not easily ascertainable. Conservatorship is a less drastic remedy than liquidation; it allows the NCUA Board the flexibility to work with credit union personnel to reopen the institution while at the same time preserving its integrity. This is accomplished by controlling the impact of outside influences which could otherwise seriously impair its viability. Liquidations may sometimes be inevitable but the value of the credit union may have been preserved, or losses reduced, for the benefit of all concerned, by the use of the conservatorship.

Since the conservatorship authority was granted, it has been used in 7 cases involving assets of over \$278 million. Estimated savings can be clearly shown in two cases during FY-64. Both

cases involved relatively new Federal credit unions which sustained substantial growth through the use of brokered funds. Due to the use of conservatorship in these two cases, the agency saved an estimated \$9 million. A savings of at least 25% was achieved in the remaining cases. Overall, we believe we have achieved over \$30 million in savings in all conservatorship cases handled thus far.

Mr. Chairman, I would seek your support once again this year for NCUA's conservatorship authority. Due to expire October 15, I believe this vitally needed tool should be made permanent by the Congress.

In conclusion, Mr. Chairman, I want to stress again that the greatest danger to credit unions is the tendency to see them, and to treat them, like any other financial institution. Surely through their financial performance in recent times, surely in the strength and self-help basis of their insurance fund, credit unions are different. But these differences are much less significant than the credit union philosophy and tradition of service -- service through non-profit, member-oriented and member-operated cooperatives. I firmly believe that, if credit union regulators, legislators and credit unions themselves can recognize these unique characteristics, credit unions will continue to grow, prosper and provide quality service for their millions of members

Thank you. I would be pleased to respond to any questions.

ESTIMATED DATA ON FEDERAL NATURAL PERSON CREDIT UNIONS

Outstanding Balances (Amounts in Millions)					Selected Ratios		
	Assets	Loans (1)	Invest's (2)	Savings	Loans/ Savings	Savings/ Assets	Invest/ Assets
• Dec. 1981	\$39,181	\$27,006	\$10,877	\$35,250	75.3	90.0	69.3
• Mar. 1982	40,922	26,825	12,264	36,992	71.5	90.4	65.6
• Jun.	42,594	26,908	13,497	38,489	78.1	90.6	63.5
• Sept.	43,836	27,671	14,824	39,689	68.7	90.5	63.1
• Dec.	45,493	27,946	15,180	41,352	67.6	90.9	61.4
• Jun. 1983	51,430	29,175	19,430	47,145	61.9	91.7	66.7
• Sept.	53,006	31,212	19,428	48,709	64.1	91.8	66.8
• Dec.	54,482	32,938	19,847	49,889	66.0	91.6	66.4
• Jan. 1984	54,770	33,270	18,979	50,438	64.0	92.1	66.7
• Feb.	55,753	33,878	19,141	51,218	66.1	91.9	66.8
• Mar.	57,549	34,510	20,246	52,905	65.2	91.9	66.9
• Apr.	58,127	35,286	20,182	53,587	65.8	92.2	66.7
• May	59,636	36,274	20,552	54,632	66.4	91.8	66.8
• Jun.	61,316	37,547	20,791	56,281	66.7	91.8	67.3
• July	61,163	38,499	20,825	56,278	68.4	92.0	68.4
• Aug.	61,500	39,578	19,182	58,205	70.4	91.4	64.4
• Sept.	62,107	40,310	18,855	58,734	71.1	91.3	64.9
• Oct.	61,935	40,727	18,610	58,655	71.9	91.5	65.8
• Nov.	62,690	41,762	18,566	57,302	72.9	91.4	66.6
• Dec.	63,658	42,122	18,567	57,927	72.7	91.0	66.2
• Jan. 1985	64,505	42,220	18,749	58,020	71.8	91.2	65.5
• Feb.	65,989	42,283	19,911	59,914	70.6	90.8	64.1

(1) Net of Allowance for Loan Losses until November 1984; after that date, the column is Total Loans.

(2) Net of Allowance for Investment Losses.

• Represents actual data based upon call report information. The other monthly values are estimates based upon sample data.

**ESTIMATED PERCENT CHANGE ON FEDERAL NATURAL PERSONS CREDIT UNIONS
(MATCHED SAMPLES)**

Total Assets				Loans Outstanding		
Period	Monthly Rate	Year to Date	Annual Rate	Monthly Rate	Year to Date	Annual Rate
• June 1983	2.3		20.9	2.3		8.3
Sept.	1.8		21.1	2.1		12.8
• Dec.	1.3		20.0	1.9		18.1
Jan. 1984	.5	.5	20.1	1.0	1.0	19.9
Feb.	1.8	2.3	19.5	1.8	2.8	22.6
Mar.	3.3	5.6	19.1	1.9	4.7	24.0
Apr.	1.0	6.3	18.7	2.2	6.9	23.4
May	1.8	8.1	18.6	2.0	8.9	27.2
• June	1.9	10.0	18.3	2.1	10.0	27.7
July	-.3	9.7	17.9	2.4	12.4	29.7
Aug.	.2	9.9	15.2	2.7	15.1	28.7
Sept.	.9	10.8	15.2	1.7	16.8	29.0
Oct.	-.3	10.5	14.7	1.7	18.5	27.7
Nov.	.9	11.4	15.0	1.3	19.8	26.8
Dec.	.4	11.8	14.6	1.5	21.3	25.8
Jan. 1985	1.3	1.3	14.3	.2	.2	22.5
Feb.	2.3	3.8	15.5	.2	.4	22.4
Total Savings				Total Investments		
• June 1983	2.1		22.5	2.4		45.8
Sept.	1.7		22.7	—		38.5
• Dec.	1.9		20.9	-.8		24.2
Jan. 1984	1.1	1.1	21.4	.7	.7	23.2
Feb.	1.8	2.7	20.4	.9	1.6	16.8
Mar.	3.3	6.9	19.3	3.8	7.4	13.5
Apr.	1.3	7.3	18.6	-.3	7.1	9.9
May	1.8	9.1	18.3	1.6	9.7	7.2
• June	1.9	11.0	18.4	1.6	10.3	5.1
July	—	11.0	18.0	-3.5	6.8	1.8
Aug.	-.1	10.9	14.9	-3.9	2.9	-2.3
Sept.	.9	11.8	14.9	-1.5	1.4	-3.3
Oct.	-.1	11.7	14.9	-3.2	-1.8	-1.9
Nov.	.9	12.6	14.7	.8	1.0	-2.4
Dec.	.4	13.0	14.6	-1.5	-.5	-2.9
Jan. 1985	1.5	1.5	14.2	1.1	1.1	-1.6
Feb.	1.9	3.4	14.9	6.9	8.0	1.6
				(14.9)**		
				(-2.7)**		

* Actual rates of change for all credit unions between annual call report cycles.

** Rate of change for 10,365 FCUs which reported in 12/83 and 12/84.

ESTIMATED DATA FOR STATE NATURAL PERSON CREDIT UNIONS

(Federally Insured)

Outstanding Balances (Amounts in Millions)

	Assets	Loans (1)	Invest's (2)	Savings	Notes Payable	Loans/ Savings	Savings/ Assets	Loans/ Assets	Invest/ Assets
• Dec. 1981	\$21,430	\$15,327	\$5,050	\$18,902	\$471	60.6	80.2	71.1	23.6
• Mar. 1982	22,354	15,023	6,071	19,795	363	75.9	80.0	67.5	27.3
• Jun.	23,058	15,151	6,757	20,557	345	73.7	80.1	65.7	29.3
• Sept.	23,484	15,392	6,435	20,931	313	73.5	80.1	65.5	27.4
• Dec.	24,092	15,284	7,517	21,638	230	70.6	80.8	63.4	31.2
• Jun. 1983	27,037	15,826	9,600	24,567	100	64.4	90.0	58.5	34.2
• Sept.	27,256	16,489	9,335	24,708	188	66.7	90.7	60.5	34.2
• Dec.	27,479	17,153	9,866	24,850	240	69.0	90.4	62.4	31.3
• Jan. 1984	27,726	17,355	8,012	25,094	231	69.2	90.5	63.6	32.1
• Feb.	27,973	17,557	8,958	25,338	294	69.3	90.6	62.8	32.0
• Mar.	28,230	17,759	9,004	25,582	284	69.4	90.7	62.9	31.8
• Apr.	28,467	17,961	9,050	25,826	209	69.5	90.7	63.0	31.6
• May	28,714	18,163	9,096	26,070	201	69.7	90.8	63.3	31.6
• June	28,968	18,368	9,144	26,317	218	69.8	90.9	63.4	31.6
• July	29,003	18,796	8,702	26,124	243	71.9	90.1	64.9	30.0
• Aug.	29,003	19,224	8,261	25,930	207	74.1	89.4	66.3	28.5
• Sept.	29,544	19,544	8,350	26,438	455	74.0	89.5	66.2	28.3
• Oct.	29,684	19,756	8,303	26,474	466	73.9	89.2	66.8	28.0
• Nov.	29,831	20,408	8,101	26,608	265	76.4	89.5	68.4	27.2
• Dec.	29,189	19,851	7,770	26,327	271	75.8	90.3	68.4	26.7
• Jan. 1985	29,480	20,050	7,721	26,721	300	75.0	90.6	68.0	26.2
• Feb.	30,194	20,110	8,169	26,134	312	76.9	86.6	66.6	27.1

(1) Net of Allowance for Loan Losses until November 1984; after that date, the column is Total Loans.
 (2) Net of Allowance for Investment Losses.

• Represents actual data based upon call report information. The other monthly values are estimates based upon sample data.
 Appendix page 3

- ESTIMATED PERCENT CHANGE ON STATE NATURAL PERSON CREDIT UNIONS
(FEDERALLY INSURED)
(MATCHED SAMPLES)

Period	Total Assets			Loans Outstanding		
	Monthly Rate	Year to Date	Annual Rate	Monthly Rate	Year to Date	Annual Rate
• June 1983	1.7	•	19.6	1.8		7.2
Sept.	.5		19.4	1.6		8.9
• Dec.	.7		17.6	1.3		15.4
Jan. 1984	.1	.1	13.7	.3	.3	13.1
Feb.	1.8	1.9	13.4	1.7	2.0	15.3
Mar.	3.2	5.1	13.6	1.9	3.9	17.9
Apr.	.5	5.8	12.5	1.3	5.2	17.3
May	1.6	7.2	12.3	1.7	6.9	19.2
• June	1.7	8.9	10.1	2.0	8.9	24.6
July	-.3	8.6	14.3	2.0	10.9	26.3
Aug.	.1	8.7	11.9	2.3	13.2	25.3
Sept.	1.3	10.0	12.0	1.7	14.9	27.7
Oct.	—	10.0	12.9	1.3	16.2	26.6
Nov.	1.2	11.2	15.2	2.2	18.4	25.6
Dec.	—	11.2	13.9	(13.7)**	17.7	22.5 (25.9)**
Jan. 1985	1.0	1.0	14.2	.4	.4	23.0
Feb.	2.1	3.1	15.0	.5	.9	18.8
Period	Total Savings			Total Investments		
	Monthly Rate	Year to Date	Annual Rate	Monthly Rate	Year to Date	Annual Rate
• June 1983	.7		21.9	2.7		46.4
Sept.	.8		17.4	-3.9		42.2
• Dec.	.8		18.4	-2.1		22.1
Jan. 1984	.3	.3	14.3	-.5	-.5	15.0
Feb.	1.1	1.4	12.8	2.6	2.1	12.2
Mar.	4.1	5.5	12.6	3.8	5.8	6.9
Apr.	.9	6.3	11.6	.2	5.8	4.6
May	1.6	7.9	10.9	1.5	7.3	1.6
• June	1.8	9.8	16.4	1.4	8.7	2.9
July	-1.0	8.8	13.7	-4.7	4.0	-2.8
Aug.	-.7	8.1	10.3	-4.8	-.8	-7.1
Sept.	1.3	9.4	10.4	.8	-.2	-11.3
Oct.	-.4	9.0	11.2	-1.9	-2.1	-8.0
Nov.	1.6	10.6	14.8	-1.6	-3.7	-3.3
Dec.	.5	11.1	14.0	(15.9)**	-.4	-1.5 (-7.7)**
Jan. 1985	1.5	1.5	14.7	-.6	-.6	-2.9
Feb.	1.6	3.1	14.8	5.9	5.3	4.3

* Actual rates of change for all credit unions between annual call report periods.

** Rate of change for 4,457 FISCUs which reported in 12/83 and 12/84.

Appendix page 4

Financial Firms Get High Marks in Survey

Credit Unions Top List But Satisfaction with Banks Is Lower Now

By LAURA GROSS

An overwhelming majority of Americans are satisfied with their financial institutions — and credit unions are their favorite ones.

A new *American Banker* consumer opinion poll finds that nine out of 10 people are very or somewhat satisfied with their principal financial institution. Just over one in 20 of the respondents say they are somewhat or very dissatisfied.

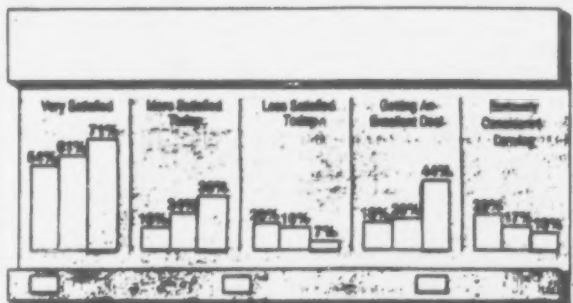
Also, most people think that their primary financial institution gives them either a pretty good or excellent deal, with only one in 10 say-

ing they get a not so good or poor deal.

These findings are from a nationwide telephone survey of how consumers view the changing financial services industry. The survey was commissioned by the *American*

Banker and conducted among 1,000 households this summer by Reichman Research, a New York-based opinion research firm.

Credit union members, the survey finds, are the nation's most sat-



isfied consumers of financial services. Compared to customers of banks and thrifts (savings banks and savings and loan associations), more than twice as many credit union members say they get an excellent deal from their financial institution.

As examples of what they like most about their credit unions, members most often volunteer "expanded services," and "easier to get a loan," although "higher interest rates" and "more courteous, personal service" also rank high.

Robert Von der Ohe, chief economist for the Credit Union National Association, said that the fact that credit union members cite "expanded services" demonstrates "that the program of expanded services as a strategy is working."

"People have always felt good

about their credit unions," he noted in a recent interview, "because there's a cooperative philosophy, a commonality of purpose that says, 'We're all in here together, and no one's trying to take advantage of anyone else.'"

Now, 15% to 20% of the nation's 19,000 credit unions have begun offering more services, such as first mortgage loans, credit cards, and access to automated teller machines. This makes their members happier, Mr. Von der Ohe maintained.

Carl A. Modecki, president of the Consumer Bankers Association, said, "You don't have to tell me what the survey found. I'm a bank customer. For the credit unions, there's a cohesiveness there to begin with. It's likely they know their members. The bank tellers down here change once a week."

His comments underscore other survey findings: Customers of commercial banks are practically as dissatisfied as those people identifying some institution other than a bank, credit union, or thrift as their main financial institution. (Consumers also could choose brokerage firms, mutual or money market funds, insurance or finance companies as their "most important financial institution.")

More alarming, commercial bank customers are the only category in which a larger percentage say they are less satisfied than say they are more satisfied with their main provider of financial services than they were a few years ago.

One banker, who chose to remain anonymous, expressed the feeling of a number of others: "Of course people are going to say they are less satisfied. Banks are in the middle of deregulation, changing strategies, unbundling prices, charging new fees. There's a whole lot of disruption going on."

Commented David Reichman, president of the research firm that conducted the survey, "If I were a banker, I'd want to know what I have to do to bring the level of satisfaction in my company up to my competition's so I'm not losing customers in the future, but gaining them."

What clues does the survey offer bankers in this regard?

Bank customers say that high fees and minimum balance requirements bother them most.

Another thing that they dislike about their banks is that, as one consumer says: "There is no personalized service as there was before."

Someone else complains: "The bank's getting too big. You always get the runaround."

Another says: "That personal touch is gone since they were bought out by another bank."

It would be easy for bankers to be complacent about the fact that more than nine out of 10 of their customers are satisfied. But industry observers suggest that this would be extremely foolish, given the fact that a sizable percentage of bank customers say they are less

satisfied today with the services they get than they were a few years ago.

As further support for their concern, these analysts point out that it is the wealthier commercial bank customers who are least likely to be very satisfied and the most likely to have become less satisfied than they were a few years ago.

Among the people who identify commercial banks as their principal institution and who earn under \$30,000, 58% are very satisfied. This compares with 44% who are very satisfied in the group earning \$30,000 and over.

For thrift institutions, the results are reversed. Fifty-nine percent of those earning under \$30,000 are very satisfied, compared to 67% who are very satisfied in the group earning over \$30,000. And for credit unions, the trend is also toward more satisfaction at higher incomes.

Additionally, a higher percentage of commercial bank customers earning over \$30,000 annually are less satisfied than those who are more satisfied. The reverse is true for thrifts and credit unions. Both show that a higher number of people in the upper income ranges are more satisfied than less satisfied.

"Of all three of the depository institutions, commercial banks do the least well in serving their own affluent," remarked Marilyn Barnewall, president of the MacGruder Agency, a marketing consultancy whose principal business is advising on banking programs for the affluent.

"Of course credit union members are happier. If they couldn't serve the needs of the market with car loans, education loans, and mortgages, they'd be in trouble. Nobody goes to a credit union to ask for \$200,000 to invest in thoroughbreds or oil and gas ventures. People ask less of them and then are satisfied when they get it," Ms. Barnewall said.

Least satisfied of all consumers in the American Banker's survey, however, are those identifying either a stockbroker, an insurance company, a finance company, a mu-

tual or a money market fund as their principal institution. (The number of people identifying an institution other than one of the three insured depositories as principal was too small for detailed analysis.)

Nonetheless, it is clear from the data that people who choose one of these nonbanks as their principal institution are less likely than those choosing commercial banks to have seriously considered moving to another principal institution over the past few years. Those calling credit unions their principal are least likely to have considered moving.

A quarter of the consumers calling commercial banks their principal institution say they've seriously considered leaving the bank for another institution. As reasons for this, most cite higher service fees and minimum balance requirements as well as less personal service.

Several retail bankers were asked whether they thought that a quarter was a lot of customers to have seriously considered moving elsewhere. Most said the figure sounded a bit high to them. They normally expect customer turnover rates of anywhere between 8% and 20%, depending on the area of the country.

While commercial bank customers most often cite higher service charges and less personal service as reasons for having seriously considered leaving, credit union members cite incompetent personnel and the desire for an institution which is more convenient.

"That's interesting to note," said Edward Furash, the Washington, D.C., banker-turned-consultant.

"Credit unions may get such high marks not because they give better service but because they give a better sense of identity."

"The smaller size, scale, and intimacy of the credit union provides a sense of group belonging that someone doesn't get at larger financial institutions," Mr. Furash said. "This implies that larger commercial banks and huge thrifts are going to have an identity crisis with their customers as regional interstate banking explodes."

"This is already happening in state after state when mergers and acquisitions occur, opening tremendous opportunities for local institutions, new banks, and others who are truly responsive to customer needs," Mr. Furash said. ■

How the Survey Was Conducted

The results of the *American Banker's* survey, "How Consumer America Views the Changing Financial Services Industry," are based on telephone interviews conducted among a scientifically selected random cross section of the American public. The cross section consisted of 1,004 respondents.

The questionnaire used for this survey was developed by Reichman Research Inc., a New York-based opinion research firm, in collaboration with the *American Banker's* senior editors. It consisted of structured as well as open-ended questions.

The sample was a stratified random digit-dial sample, which was drawn in a manner so that all telephone-owning households in the continental United States, listed and unlisted, had a theoretically known chance of being selected.

Heads of households, co-heads, and spouses of heads of households, 18 years of age and older, were eligible to be interviewed. Prospective respondents were called back up to three times before the interviewer moved on to the next telephone number.

Population Reflected

The resulting number of respondents in each demographic category — income, age, sex, education, race, and geographic location — reflect percentages of the population as a whole.

All interviewing was conducted between July 20 and Aug. 1, 1984, by specially trained and briefed professional interviewers working out of two central-location telephone-interviewing facilities. The average interview took 18.4 minutes to conduct.

In any random sample, one would expect minor deviations in key population characteristics to occur. In this sample, prior to analysis, appropriate weighting was applied to correct for these minor deviations.

Reichman Research processed and analyzed the results flowing out of the survey and summarized the key findings for the *American Banker*.

Margin of Error

In reviewing the survey results, the reader should be aware that the expected sampling error for a sample consisting of 1,000 interviews, at a 50% response and at 95% confidence — that is, reliability — rate, is plus or minus 3 points. This "margin of error" applies to the total sample. The responses for subgroups are based on smaller sample sizes and therefore are likely to have a greater margin of error.

For a more detailed description of the methodology used in this survey, for a copy of the questionnaire, or for special data requests, readers can contact either David Reichman, president, or Stephen O'Brien, vice president, Reichman Research Inc., 3 East 44th St., New York, N.Y. 10017. The telephone number is 212-694-7709.

Reichman Research is a marketing and opinion research firm that conducted the *American Banker's* 1983 survey, "How Corporate America Views the Changing Financial Services Industry."

CREDIT UNION NEWS

March 28, 1985

CU's Unaffected By ESM Troubles; Hotline Credited

WASHINGTON. — Thanks to tips from credit unions to the NCUA Investment Hotline (800-424-3205) and to safety and soundness concerns raised by NCUA, credit unions apparently were not caught in the E.S.M. Government Securities scandal that left scores of thrifts and municipalities facing losses of up to \$315 million.

"Communication, cooperation and greater sensitivity by credit union officials to the possible dangers of brokered investments were the keys that kept credit unions out of E.S.M.," said NCUA Chairman Edgar F. Callahan. "Credit union officials, contacted by E.S.M. about an investment they had not seen before, shared their uneasiness with NCUA. We raised legal and safety and soundness concerns and got the word out to our regional and field staff. It was a cooperative effort by people at all levels of the credit union movement who cared about the possible impact on others. I don't know of any other financial system that has this much concern for the common good."

NCUA became aware of E.S.M. last summer when three credit unions called the NCUA Investment Hotline to say they'd been approached by E.S.M. salesmen offering a "riskless" Treasury bill arbitrage program that in the words of one credit union official "sounded too good to be true."

Here's how it worked, as explained by NCUA's Ed Dupcak, who manages

(Continued on page 25)

NCUA Hotline Kept CUs Out Of ESM

(Continued from page 1)

the Agency's investments and mans the hotline: The credit union uses \$1 million in government securities from its portfolio to borrow \$10 million on margin through E.S.M., with an agreement by E.S.M. to repurchase the securities at a later date for a higher price.

Under a repurchase transaction, the securities are typically held for safekeeping by a third party. In economic terms, the transaction resembles that of a secured loan to the securities dealer (in this case, E.S.M.). In the example provided by E.S.M., the credit union would have received a gain of \$21,000 from the transaction.

"We knew it was full of baloney," said Greg Manweiler, a vice president of Langley Federal Credit Union, Hampton, Va., who was approached by E.S.M. and called the investment hotline to inquire about it. "It sounded like a free lunch. I hope no one in credit union land got hurt by it — we didn't do anything with it."

NCUA also had safety and soundness concerns and immediately called E.S.M. and asked for more information. E.S.M. salesmen met with NCUA's Assistant General Counsel Steve Bisker who reviewed the investment. Mr. Bisker said it raised legal and safety and soundness issues and he told E.S.M. not to market to federal credit unions until they could document the program to NCUA's satisfaction. E.S.M. never followed up.

NCUA next got the word out to its regional and field staff, alerting them to the situation and urging caution. In a memo to staff dated July 17, 1984, NCUA called the E.S.M. plan a "pyramiding transaction" which raises safety and soundness issues. The E.S.M. type of transaction is legal for federal credit unions only if the credit union actually takes possession of the securities or is given documentation that the securities are being held in the credit union's name by an independent third party. "As the most recent bankruptcy cases of brokers indicate, the

safety of this arrangement is dependent on the financial stability and integrity of the broker," NCUA said.

E.S.M. based in Fort Lauderdale, Fla., was closed March 4 by a court order obtained by the Securities and Exchange Commission. The S.E.C. has charged a variety of violations of anti-fraud provisions of securities laws. In the three weeks since E.S.M. collapsed, there have been daily revelations about who was involved in E.S.M. and to what extent.

NCUA believes efforts by credit unions and the agency to share information, coupled with the increased sensitivity of credit union managers to the potential dangers of brokered investments, resulted in no credit unions becoming involved with E.S.M.

The NCUA Investment Hotline, which began operating in May 1984, is an example of a preventive rather than a reactive response to investment problems. When two or three examples of illegal investments occurred within several weeks early in 1984, the Agency decided to try this approach.

Using an 800 toll-free number already in place, the hotline provided a centralized reference point and gave credit unions, state and federal examiners, brokers and other groups serving credit unions an opportunity to call and ask about an investment before making a decision. Dupcak and Bisker have set up files to facilitate cross checks to determine if specific investments or institutions have been the subject of supervisory actions or decisions. The hotline averages 10-15 calls per day and potential and actual investment problems have been identified in dozens of cases. As Langley Federal Credit Union's Manweiler put it: "I'd like to see credit unions use the investment hotline — it's only a dial away and it can save you tons of money."

Dupcak mans the hotline from 8:30 a.m. to 4 p.m. Monday-Friday. Persons who call before or after those hours may leave a message and Dupcak will return the call. The number is 800-424-3205.

WALL STREET JOURNAL

APRIL 19, 1985

Washington Wire

A Special Weekly Report From
The Wall Street Journal's
Capital Bureau

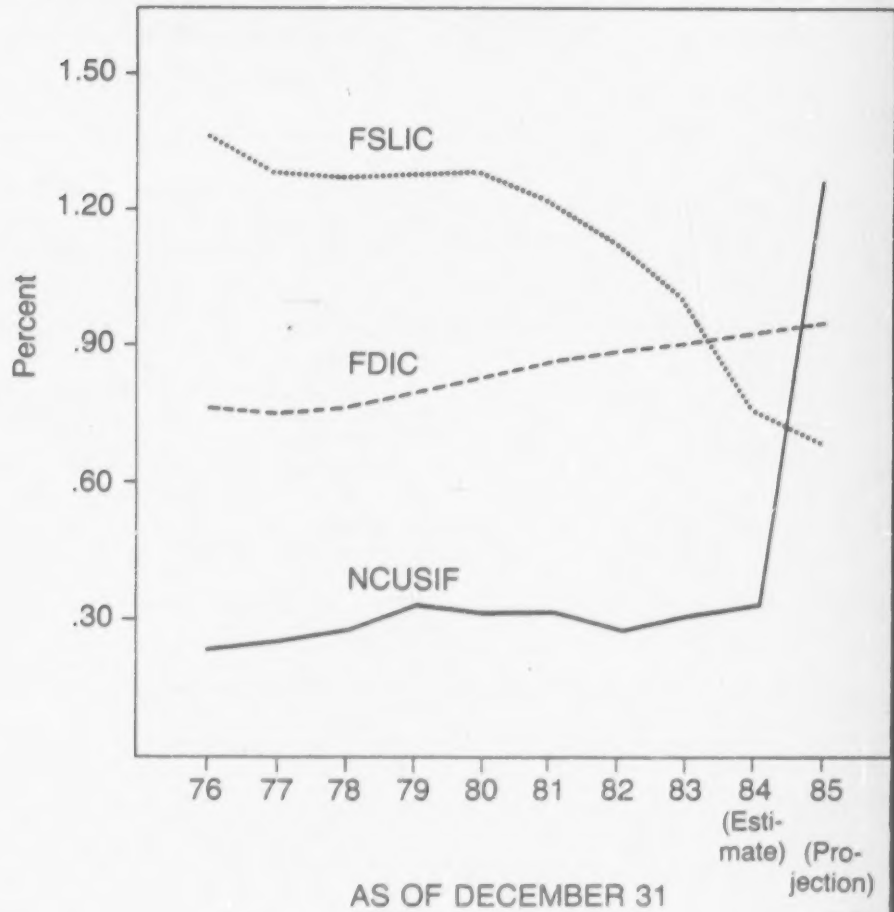
CREDIT UNIONS CROW at their health compared with others' ailments.

They stage a comeback following severe troubles only a few years ago. The number of credit-union failures dropped to 38 last year from 251 in 1981; their insurance fund is now better capitalized than either the bank or savings-and-loan funds. About 41 million Americans belong to federally insured credit unions.

Industry officials credit Edgar Callahan, chairman of the National Credit Union Administration, with aiding the turnaround. But he and two top aides leave next month. The Reagan administration taps ex-Sen. Roger Jepsen, defeated for reelection last year, to replace him.

"We don't like to trade off the troubles of others, but we don't want to be lumped in" with banks' and thrifts' woes, a trade-group spokeswoman says.

The Three Federal Deposit Insurers' Insurance Fund Reserves (Equity) as a Percentage of Total Deposits/Shares in the Depositories Insured by that Insurer



The CHAIRMAN. Thank you, gentlemen.

First of all, Mr. Callahan, let me congratulate you on the job that you have done. For those who don't know, Mr. Callahan left his position of Chairman last Friday. With the delay in the hearings we appreciate the fact that you agreed to come and testify anyway, even as a private citizen.

I personally have enjoyed working with you very much. We did have a good result working on the recapitalization together and your efforts on that were absolutely outstanding. I think you've done an outstanding job in your tenure and wish you well for whatever new ventures you are going into.

I apologize to both of you for running out on you again. I'll have to submit our questions to you in writing. I don't know what's happened to the Senate. Two votes in a half an hour, I mean, I would have expected at least 2 more hours of rhetoric and debate before another vote so I was absolutely surprised.

But I do appreciate both of you being here today and we will have some questions for your response in writing for the record.

Thank you very much.

The committee is adjourned.

[Whereupon, at 12 noon, the hearing was adjourned.]

[Response to written questions of Senator Garn from H. Joe Selby and Edgar F. Callahan follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM H. JOE SELEY, ACTING
COMPTROLLER OF THE CURRENCY

1. Please provide to the Committee an analysis of bank failures over the last 3 years as well as a forecast of the number of future failures.

Over the 1981-1984 period, 164 commercial banks failed. Most of these banks were small one- or two-office institutions located in small urban or rural areas. Three out of four failed banks had deposits of less than \$30 million; only one out of nine had deposits in excess of \$100 million.

The primary causes of bank failures during the 1981-1984 period were the same as in previous years -- mismanagement and poor loan quality. Deficiencies of management, to one degree or another, are always present in a failed bank situation. How well a bank survives external stress depends on management quality, which is manifested in, among other things, prudent lending decisions and adequate internal controls.

Over the last three years, failed banks had extensive lending problems. These lending difficulties reflected the overall economic declines of the early 1980s as well as adverse conditions in the agriculture, construction and energy markets. In many failed banks, outsider fraud and criminal conduct by insiders contributed to the lending problems.

It is likely, based on current problem bank trends, that bank failures in 1985 will be higher than in previous years. However, the number of bank failures in 1985 and future years depends also upon the strength of the economy in general, and the recovery of certain sectors in particular. Continued weaknesses in the agriculture and energy sectors, for example, would portend a continuing high rate of bank failures. Alternatively, further declines in interest rates would provide significant relief to banks through reduced funding costs and through reduced real debt burdens for bank borrowers, and thereby moderate the number of bank failures.

-3-

2. Many analysts claim that commercial and personal loans are in the process of being "securitized". They point to commercial paper, mortgage-backed securities, auto loans, and junk bonds. They predict that this trend will increase. Do you agree with this analysis and forecast? If so, what does this imply for the future earning capacity of bank holding companies?

The conversion of loans to marketable securities has grown because the process produces benefits for the originators of the loans, the purchasers of the created securities, and the borrowers whose credit underlies those securities. This is evidenced by the success of mortgage-backed securities and other securitized assets such as auto loans. In view of this, it is likely that the securitization trend will continue.

It is difficult to predict how bank holding companies' earnings will be affected by this trend because there are both positive and negative effects. On the positive side, securitization enhances the liquidity of bank assets, provides the opportunity to maintain servicing relationships and generate fee income in the face of increased competition, and enables banks to improve their return on assets by removing loans from the balance sheet.

On the negative side, the trend raises some concerns. If a bank's highest quality assets are sold through the creation of securities, the average quality of the bank's portfolio may decline, increasing the riskiness of the institution. Moreover, the growth of securitization of the assets of nonfinancial firms opens new financing avenues to these firms. This may reduce their reliance on traditional bank lending, resulting in a somewhat reduced market share for banks.

3. Mr. Budd of Travelers Insurance Company testified that it would have been irresponsible for Travelers not to have activated its bank charter in view of the thrust and strategic announcements that many of Travelers' competitors have made. Given the changes occurring in the financial services marketplace, would it be irresponsible not to permit banks and bank holding companies to respond to the marketplace and their competitors by expanding their product lines to the extent you have suggested in your testimony? What are the risks to the financial system as a whole and banks specifically, if Congress does not authorize product and service flexibility?

Banking organizations should be permitted to offer a wider range of financial services or they will continue to lose customers to less restricted financial service providers. Without new securities, insurance and real estate powers, banks' vitality and the role they play in our economy could gradually diminish.

Consumers are much less interested in who provides a product or service than they are in obtaining desired products and services conveniently and at competitive prices. The rapid growth of money market mutual funds during the 1970s demonstrates this point. More recent examples of nonbanks' attempts to meet consumer demands that suggest further incursions into bank territory include:

- o New developments in home finance. K mart has made space available in nine of its New Jersey stores to a mortgage banking subsidiary of American Can Company. Shoppers can determine within minutes how much of a mortgage they qualify for, and as an added incentive to obtain their mortgage through this service, they receive credit towards purchases at K mart stores.

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- o New full-service outlets for financial products and services. Montgomery Ward recently established "Moneyplex" centers. The test-market centers in Houston offer: full banking services through Empire of America Federal Savings Bank in Buffalo, New York; home and auto insurance through Montgomery Ward Insurance Group; discount brokerage services through Cadden Company; and real estate and relocation services through Gallery of Homes Inc.
- o New corporate funding sources. Rather than obtaining loans from banks, corporations can borrow millions of dollars with the assistance of creative investment bankers by issuing securities backed by assets such as future rental payments from equipment leased, shared equity in projects, etc.

In addition to banks' need for increased product and service flexibility to meet competition from nonbank financial service providers, banks also need expanded powers as a source of additional income. Diversification opportunities would enable banking organizations to smooth out earnings and to ensure that their long-term health is not endangered by an excessive commitment to one line of business.

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4. Mortgage credit in this country once was provided almost exclusively by traditional depository institutions that held mortgages until their maturity. Today, more and more mortgages are sold to investors in the secondary market.

A similar development has occurred in the provision of commercial credit. Whereas commercial banks were once the almost exclusive providers of commercial credit, the commercial paper market has enabled corporations to acquire commercial credit by selling their debt directly to investors.

Would you agree that explicit authorization for banks to underwrite mortgage-backed securities and commercial paper is needed to preserve their traditional role in the provision of mortgage credit and commercial credit? Why?

Explicit authorization to underwrite mortgage-backed securities and commercial paper would not represent a bold step in the authorization of new bank powers. However, it would enhance banks' ability to better respond to developments in the mortgage and commercial credit markets -- markets they are currently heavily involved in.

Underwriting authority for commercial banks would enable them to meet demands in the mortgage market and the market for commercial credit. With authority to underwrite mortgage-backed securities, banks could offer an attractive investment instrument to their customers that is currently available only through securities dealers. With commercial paper underwriting authority they could expand the financing options they could offer to business borrowers.

On a broader level, the question of expanded powers should not be based as much on consideration of institutions' "traditional" roles, but rather on what will enhance the performance of financial markets generally. We believe that allowing banks to respond flexibly to market demands is an important element of promoting competition.

5. Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment activities than commercial banks in the U.S.

Are you aware of serious safety and soundness problems that have arisen from this combining of investment banking and commercial banking in London?

If a financial institution in London can offer both commercial and investment banking services to a corporate customer, does that financial institution in London have a competitive advantage over a financial institution in the U.S. that can offer only one of the services?

We are not aware of any serious safety and soundness problems for the British banking and financial systems arising from institutions' conduct of both investment and commercial banking. Further, no unusual safety and soundness problems for U.S. bank holding companies have resulted from their involvement in investment banking there.

A financial institution that can offer both commercial and investment banking services to corporate customers naturally has a competitive advantage over a financial institution more restricted in its offering. However, it does not follow necessarily that a financial institution in London has a competitive advantage over a financial institution in the U.S. because a U.S. financial institution can establish foreign operating entities (in London and elsewhere) and thereby provide, from that locale, both commercial banking and investment services to corporate customers who desire them.

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6. I am told that a majority of failed banks had "CAMEL" ratings of 1 or 2 on the call report most immediately preceding their closure. If true, this has profound implications for the ability of bank examiners to spot and deal with problems. Can you confirm this allegation? Can you supply for the record what the CAMEL ratings were for those banks under your jurisdiction which have failed on the call report immediately preceding their failure? How do you explain those instances where the previous exam did not disclose the institution's danger of failure?

The allegation that the majority of failed banks had CAMEL ratings of 1 or 2 in the examination most immediately preceding their closure is inaccurate. In fact, as the table below discloses, the contrary is true: the majority received ratings of 4 or 5. In 1984, 88% of the national banks that failed received a rating of 4 or 5 in the last examination before failure; and over the period 1981 - 1984, 84% received these same ratings.

Ratings Resulting from Last Exam
Before Failure
(Number of National Banks)

RATING	YEAR OF FAILURE				TOTAL	% OF TOTAL
	81	82	83	84		
1	0	0	0	0	0	0%
2	0	2	0	2	4	11
3	0	2	0	0	2	5
4	0	3	1	1	5	14
5	1	3	8	14	26	70
TOTAL	1	10	9	17	37	100%

The few instances where the previous exam did not disclose the institution's danger of failure involved situations where the bank's condition deteriorated rapidly and were due to a variety of reasons, including fraud and illegal lending practices.

Callahan & Associates

301-656-8890

June 26, 1985

The Honorable Jake Garn
505 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Garn:

Please accept my apology for being late with responses to your letter of June 11th, it's tough with no support staff yet.

Question: In you opinion, what are the challenges facing credit unions over the next decade?

Answer: The real challenge can be summed up in one phrase "management capability"? Credit unions must remain up to the task of managing their organizations in the ever intensifying competitive world of tomorrow.

Question: Given the level of current interest rates and the average credit union loan rates, what dangers or problems will credit unions face if we fail to remove this federal usury ceiling?

Answer: Failure to remove the usury ceiling at this time would not appear to create a problem. But it should be done eventually and ideally not during a crisis. Therefore, I would say that now is the best time to do it.

Question: Do you believe NCUA's experience with conservatorship authority and/or its share insurance recapitalization would lend itself to improving the practices of the other regulatory or insurance agencies? Why?

Answer: I am always slow to tell others how to do their business. At the same time I do believe in learning from others. NCUA has been very effective in dealing with the credit union industry because NCUA respects the industry it regulates. Others should

E. F. Callahan

Charles W. Filson

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The Honorable Jake Garn
June 26, 1985
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examine NCUA's experiences and incorporate those programs that would be helpful. We used resource sharing, i.e., proven professionals from one credit union to help other problem credit unions during conservatorship and otherwise. The capitalization is not a panacea, but it should be carefully examined by FDIC and particularly FSLIC. But, as you know we did not impose an NCUA solution on the credit unions; we worked with them to arrive at a workable plan...and it has worked well.

Again, let me thank you, not only for the opportunity to testify, but also for the courtesies that you and your staff have shown to me and my staff over the past 3 1/2 years.

Sincerely,



E.F. Callahan
Senior Partner

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY PART I

TUESDAY, MAY 14, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Hecht, Proxmire, Riegle, Sarbanes, and Dixon.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This is the second in our series of oversight hearings on the financial services industry and the changes that have occurred in the industry since we convened here last year.

Last week we heard from the principal bank regulators, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, and the FDIC. We also heard from NCUA, the Federal credit union regulator.

Today we are going to continue with the viewpoints of the regulatory agencies with Mr. Ed Gray bringing us up to date on Federal thrifts and State regulators and informing us about changes in the State-chartered portion of the financial services industry.

While the law must be sensitive to abuses, it should be developed in a manner that does not impede the valuable activities that have resulted from competition. The marketplace has wisely used the alternatives available in the dual banking system to test different approaches of financial services.

The law should evolve in a manner compatible with the developments of the marketplace. This implies that the law should encourage the existence of the dual banking system we have had in this country for more than a century.

With these thoughts in mind, I am anxious to hear the comments of the witnesses today on both geographic and product expansion and the process of change in the financial services industry.

Mr. Gray, we are happy to have you with us today. Please proceed with your testimony.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME
LOAN BANK BOARD

Mr. GRAY. Thank you very much, Mr. Chairman.

Mr. Chairman and distinguished members of the
Committee:

INTRODUCTION AND OVERVIEW

It was little more than two years ago that I assumed my responsibilities as Chairman of the Federal Home Loan Bank Board, shortly after the Board had put into effect enabling regulations to carry out the intent of the historic Depository Institutions Act of 1982.

That landmark legislation, which bears your name, Mr. Chairman, was meant to provide the thrift industry with new and necessary elbow room to compete effectively in an emerging and fiercely competitive financial services environment.

In my view, the intent of the Garn-St Germain Act reflected, and indeed reaffirmed, the longstanding public policy mission of thrift institutions to finance homeownership and housing related investments.

The preamble to the Act states in clear, explicit language what the Congress had in mind: "An act to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans."

The home mortgage lending institutions Congress referred to were thrift institutions whose primary purpose was, and is, to help assure the availability of home mortgage loans.

Nothing in the Garn-St Germain Act was intended by the Congress to convert thrift institutions into commercial banks. Nor did the legislation come even close to doing that.

Indeed, the Congress was careful to define the limits of commercial lending and commercial real estate lending for thrifts. It was clear that these limited bank-like powers were meant to enable thrifts to shorten some of the asset maturities on their balance sheets and provide additional avenues of profitability at a time when most of their assets were in long-term, fixed rate mortgages which were yielding less than their cost of money. Mortgage interest rates had risen to historic levels. The housing market had dwindled in size.

When I assumed my chairmanship, only one in four mortgages being made by thrifts was in adjustable rate form.

That has changed significantly. The public has accepted the adjustable rate mortgage which now enables our thrift institutions to tie much more closely mortgage lending rates to the fluctuating cost of funds.

The deregulation Congress intended for thrift institutions was different from the sort of deregulation which has been conferred on other kinds of businesses, such as airlines and trucking,

These kinds of companies are not underwritten for risk of loss by the kind of financial safety net represented by the federal deposit insurance system which, in this context, guarantees the insured deposits placed by savers and investors in our federally-insured depository institutions.

And, in this regard, depository institutions are the cornerstone of America's financial system. They are unique private sector instruments of public policy. The stability of our financial system is very largely dependent on public confidence in our system of federally-insured depository institutions.

America's FSLIC-insured savings institutions are members of the Federal Home Loan Bank System, a separate and distinct credit, deposit insurance and regulatory apparatus which is governed by the Federal Home Loan Bank Board acting in its surrogate role for the Congress.

This model system has served the country well for more than a half century and, in my opinion, its existence has had more to do with making America a nation of homeowners than any other single factor.

The public policy underpinnings and rationale for the Federal Home Loan Bank System were established in the Federal Home Loan Bank Act of 1932, the Homeowners Loan Act of 1933 and the National Housing Act of 1934 which created, and still governs membership in the FSLIC. The primary housing finance role of the Federal Home Loan Bank System and its member institutions was reaffirmed in the Garn-St Germain Act. And, late last year, the Task Group on the nation's financial regulatory structure headed by Vice President George Bush again unanimously reaffirmed the role and separateness of the Federal Home Loan Bank System and its members.

Nevertheless, confusion and misunderstanding about what the Congress had in mind when it passed the Garn-St Germain thrift deregulation Act persists.

Some state legislatures have gone well beyond the confines of those activities Congress found suitable for federal deposit insurance for thrifts and have enabled their own state-chartered savings institutions to go into all manner of "entrepreneurial" endeavors, irrespective of the public policy foundations of the Federal Home Loan Bank System.

The Garn-St Germain Act enabled federal thrifts to extend both mortgage credit and limited commercial credit, and permitted certain "equity" investments within a three-percent service corporation asset basket.

On the other hand, the California legislature, for example, went so far as to allow its state-chartered savings institutions to engage up to 100 percent of assets in service corporations and in direct equity investments. As a result, these California institutions have used their preferential thrift status to buy and operate, or take equity positions in, all manner of enterprises, including fast food restaurants, wind farms, oil drilling operations and broadcasting entities, whether or not these endeavors have anything to do at all with the business of being a thrift.

In some cases there has been very little diversification in such equity positions taken.

I believe the Congress ought to look closely at the apparently unintended results of this kind of thrift deregulation which, again, has gone far beyond what was intended by Garn-St Germain -- especially when such endeavors are operated on the implicit full faith and credit of the United States and also may be underwritten and financed out of federal credit resources.

It is, after all, the federal government -- and ultimately the federal taxpayer -- that is called upon to underwrite the risk of loss, and actual losses, which can result from such "entrepreneurial" endeavors.

In our view, the Congress defined what it found suitable for federal deposit insurance for thrifts in the Garn-St Germain Act. You, Mr. Chairman, and Senator Proxmire, have introduced by request Senate Bill 759, legislation proposed by the Bank Board, which would establish a supplementary risk premium which would be paid to the FSLIC -- over and above regular insurance premiums -- by institutions which choose to engage in activities which exceed those authorized by the Congress for federally-chartered thrifts.

As you know, state legislatures which require their own state-chartered savings institutions to be FSLIC-insured, but which also authorize activities which go far beyond those permitted by the Congress for federal thrifts, are held harmless from any risk of loss, or actual losses, to their state treasuries.

At a time when the resources of the FSLIC are under strain, and when more states appear to be moving toward additional state thrift powers, it seems to me the time has come to implement a risk premium system which better protects the FSLIC from the risk of loss from such activities.

The magnitude and diversity of risk the FSLIC is being called upon to underwrite on the reserves of our present "group insurance plan," where the same proportional insurance premium is charged irrespective of the risk of loss to the insurance fund, is simply not rational in our view. Because such a risk premium cannot now be assessed, for the purposes I have described, the only remaining method of underwriting the risk of loss to the FSLIC is through the regulatory process.

The risk premium plan the Bank Board has proposed, again this year, would allow the dual federal-state thrift system to work in a more rational manner by recognizing the fundamental thrift deposit insurance role of the federal government and the role of the states in determining additional appropriate powers for their own state-chartered savings institutions.

In this connection, some in and out of government have sought to compare so-called non-bank banks with what they call non-thrift thrifts. While I have great difficulty with such comparisons, I am concerned, as I suggested before, that some state-chartered thrifts are now engaging in activities which are

not remotely related to the role thrifts have ever played, or have ever been expected to play. The Bank Board, a little over a week ago, submitted additional legislative proposals which we asked to be introduced by request. One of them would grant authority to the Bank Board to establish a laundry list of approved activities -- roughly similar to the approach contained in the Savings and Loan Holding Company Act for multiple S&L holding companies.

I would like, for a moment, to discuss this recent legislative submission and to clear up some confusion and misunderstanding that has surfaced in several reports I have read about our proposal. Perhaps it would be helpful if I state for the record what our proposal does do and what it does not do.

First, our proposal would legislatively establish that the FSLIC could reject an application for federal insurance if there was no showing of "need" for the applicant institution in the community to be served or if there is inadequate supervisory capability at either the state or the federal level.

Second, the legislative proposal would establish priorities of unsecured creditors against a receivership estate, and would permit the FSLIC to receive reimbursement for amounts paid to

insured depositors before uninsured depositors are paid.

Third, our proposal would remove the tiered bidding process under the emergency acquisition provisions of the Garn-St Germain Depository Institutions Act of 1982.

Finally, the recent submission would limit the activities of state-chartered, FSLIC-insured institutions to those permitted for federally-chartered thrifts, for multiple savings and loan holding companies and their subsidiaries, or by the FSLIC, and by regulation.

With respect to what the submission would not do -- the proposal would not strip state-chartered, FSLIC-insured institutions of all of their state authorized powers. Likewise, it would not limit state-chartered, FSLIC-insured thrifts to only those powers permitted for federals.

Let me say again -- the proposal would merely attempt to impose some rational restrictions on those activities that are not a proper incident to the operations of a thrift and which place an undue burden on, and pose an unnecessary risk to, the FSLIC.

If you will allow me to reinforce my earlier statement, and clear up any misunderstandings, once and for all, I would like to repeat what the submission does and does not do. The

proposal was never intended to, and does not, unreasonably impinge upon states' rights and the dual banking system to which, as I will discuss later, I remain committed. Rather, it is merely another means to protect the FSLIC from the stress posed by certain state-authorized activities that are not a proper incident to what a thrift institution should, in fact, be doing.

Finally, I want to say that I and my colleagues at the Bank Board are strongly opposed to the oft-repeated blandishments of my fellow chairman of the FDIC that the FSLIC be merged into the FDIC. That suggestion would solve nothing. It would not strengthen the FDIC nor would it bring to bear the kind of discipline needed to face up to the needs, and shore up the financial resources, of our fund by the savings institutions industry.

Worse yet, it would erode the foundations of the integral and separate credit, deposit insurance and regulatory apparatus known as the Federal Home Loan Bank System -- that model system which has served the housing finance needs of three generations of American families so well for so long. Some of those who placed their signatures on the final document of the Vice President's Task Group on the nation's financial regulatory structure -- which unanimously recommended that the FSLIC be operated completely separate from the FDIC -- may be suffering from an unintended lapse of memory.

THE STATUS OF THRIFTS AND THE FSLIC

Before commenting specifically on the legislative goals which the Bank Board believes are vital to restore stability, I would like to put our specific concerns in context.

1. Housing Mission Reaffirmed

During 1983 and 1984, the Task Group chaired by Vice President Bush conducted one of the most extensive reviews of the regulation of financial services in U.S. history. Although the Task Group recommended a number of legislative changes to improve the regulatory process, its most important contribution to the savings institution's future was its unanimous reaffirmation of thrifts' continuing and unique housing function, and the Bank Board's distinct and special role in regulating the industry. Last year, thrifts put on their books a record \$165.6 billion in mortgage loans, 20 percent more than in 1983. Thrifts also increased their share of permanent loans originated on 1-4 family property to 48 percent from 40 percent in 1983, only moderately less than the peak attained in the mid-1970s.

Our overall data supports the conclusion the federal thrifts have used the limited new authorities granted by the Garn-St Germain Act exactly as its drafters intended -- to gradually restructure their portfolios while continuing to maintain their primary home finance role. Our figures on how all FSLIC-insured thrifts have used the various new asset powers granted at both the federal and the state level also demonstrate generally, that the

business as a whole is proceeding cautiously to supplement its traditional home lending activities. While FSLIC-insured institutions continued to increase their holding of non-mortgage loans newly authorized by recent legislation during 1984, such loans accounted for only 2.9 percent of assets at the end of the year.

2. Economic Conditions

Although the business significantly increased its already large contribution to housing markets in 1984, both the industry and the FSLIC fund which undergirds it are under strain. Today, thrifts continue in a fragile transition period, and managers have just begun to restructure their portfolios to avoid the mismatches in asset and liability maturities which resulted in losses in the 1980-1982 period. The industry's net worth fell by nearly one-half during this period, almost every savings institution in the country suffered severe balance-sheet losses, and fully 860 institutions ceased to exist. Overall industry capital fell from a ratio of net worth to assets of 5.59 percent at the end of 1979, to 3.88 percent as of December, 1984. This reflects an enormous drop from the six percent and higher ratios of the 1960s, and the first half of the 1970s.

Downward pressures on earnings and capital as a result of deeply embedded portfolio mismatch problems have continued to plague the industry. Each year from 1981 through 1983, over one-third of all thrifts reported losses. At the end of 1984,

29 percent of the industry had a ratio of regulatory net worth to total assets of less than three percent; for the year as a whole, 25 percent of FSLIC-insured institutions were still operating in the red. Net estimated income in 1984 was only \$1.7 billion (including \$0.6 billion resulting from the extraordinary Freddie Mac stock dividend), representing a return on assets of only 0.19 percent, a decline from the \$2.0 billion income of 1983, with a return on assets of 0.27 percent. While these figures represent a significant improvement over the operating losses experienced in 1981-1982, they were sharply below the level of profits prevailing in the late 1970s when the industry was considered, by relative standards, at the peak of health.

As of this date, we have only preliminary and incomplete information on thrift profitability during the first part of this year. Nevertheless, it is clear that there has been a significant turn for the better as a result the sharp decline in market interest rates that took place late in 1984. Early this year, the delayed impact of this market change began to be reflected in a reduction in the cost of funds for thrifts while earnings from mortgages and other investments remained relatively stable. As a consequence, it appears the annualized return on assets for the industry during the first quarter was in the 10 to 15 basis point range despite the special FSLIC assessment. This is in contrast to the underlying situation

during the fourth quarter of last year when all of the industry's profits reflected the special Freddie Mac stock dividend and portends well for the remainder of the year.

The industry's thin capitalization and continued vulnerability to interest rate swings has inevitably aggravated strains on the FSLIC. If a troubled institution has some net worth, the FSLIC can control the cost of receivership. But if a failed thrift has no capital, the FSLIC's exposure, as a practical matter, is open-ended.

The recent trends in rapid growth and direct investment compounded the pressures exerted on the FSLIC by the industry's earnings and capital fragility. While the Bank Board recently took action in January to address these problems through tighter capital requirements and oversight of direct equity investments, these measures alone cannot totally relieve the new strains that have appeared in the FSLIC's caseload. During 1984 we detected a very disturbing trend in the underlying reasons for failures falling on the FSLIC's doorstep. Three years ago, roughly 80 percent of FSLIC cases were primarily caused by interest-rate spread problems, while 20 percent were due primarily to asset problems. For 1984, that ratio almost completely reversed itself to 70-30 percent -- with the result that a very substantial portion of the current FSLIC caseload is characterized by bad assets.

I cannot overemphasize the importance of this shift in the nature of the FSLIC's problems. As a percent of size of problem thrifts, asset quality cases have proven to be up to five times as expensive as interest-rate spread failures for the FSLIC to resolve.

With interest rate spread problems, our losses were at least partially limited by the high credit quality of the underlying assets. If a prospective bidder wanted to buy one of our institutions with interest-rate spread problems, we could quantify the magnitude of the losses involved and the bidder could hedge subsequent interest-rate risk through the use of widely traded financial instruments, such as interest-rate swaps or financial futures. In the early 1980s, because of these features, FSLIC found that disposing of thrifts that failed due to interest-rate spread problems was generally practical, and could be accomplished in a way which preserved the value of a failed savings institution's franchise.

In stark contrast, our experience in working out assistance agreements when dealing with asset quality problems has proven far less encouraging. Generally, we have found that thrift institutions which have failed due to asset quality problems have often taken on a wide variety of commitments and liabilities with losses that are often difficult to quantify. The assets of such institutions usually consist largely of raw land or half-completed real estate projects. Losses are great. In dealing with asset quality failures, we have found all too

often that liquidation has become the only alternative. As the FSLIC caseload has shifted toward asset problems, our actual and projected costs have increased dramatically.

Such developments are of special concern, given the current condition of the FSLIC. FSLIC reserves at year end stood at less than \$6.0 billion, which represents a ratio of FSLIC reserves to insured deposits of only 0.76 percent. Moreover, the current book value of FSLIC reserves represents a decline from the previous year: this is the first time in its history that the FSLIC has recorded such a decline. Historically, the reserve ratio has averaged 1.2 percent, peaking at 2.12 percent in 1970. Since then the ratio has declined sharply, falling from 0.92 percent at the end of the third quarter of 1984 to 0.76 percent at year's end. That ratio would significantly decrease again if projected losses to the Fund's reserves were subtracted from FSLIC book reserves at the end of 1984.

The current ratio is steadily approaching a point similar to that which prompted Congress, in 1962, to impose an additional insurance premium or secondary reserve on FSLIC-insured institutions. However, in 1962 the industry's ratio of real net worth to assets was 7.04 percent. This contrasts sharply with the current regulatory net worth ratio of 3.88 percent, which vastly overstates tangible net worth due to currently permitted accounting procedures.

Even without a significant increase in interest rates, we foresee a continued drop in the current ratio to insured deposits of both book FSLIC reserves, and the effective usable reserves of the Fund, due to the emerging problems now faced by the FSLIC as a result of rapid growth in federally insured deposits and the disturbing upward trend in asset quality problems at some institutions.

Finally, the FSLIC's ability to effectively husband its resources has been severely hampered by the continued existence of the so-called non-bank bank loophole. Proliferation of these "loophole banks" has reduced the incentive for banks and bank holding companies to obtain interstate rights and for other corporations to enter the thrift industry through acquisition of weakened thrifts. The effect on FSLIC has been, and will continue to be, absolutely devastating unless, and until, Congress closes the non-bank loophole, once and for all.

BANK BOARD LEGISLATIVE PROPOSAL (S.759)

Given this backdrop, the Bank Board earlier this year developed legislation which we believe is vital to restore balance to the thrift regulatory system and reaffirm its historic Congressionally mandated mission of providing economical home financing. Our legislative proposal, (S. 759), incorporates four fundamental principles which we believe must guide any reform.

First and most important, legislative reform must modernize and protect the viability of the FSLIC insurance system which continues to serve the historic function of maintaining public confidence in the financial system.

Reform also should reaffirm Congress' longstanding commitment to preserve the independent credit, deposit insurance and regulatory framework for housing-oriented lenders. Second, such legislation should acknowledge and reinforce the basic differences, in function and statutory authority, between thrifts and banks. Third, any proposal must preserve and enhance, not reduce, the attractiveness of the thrift charter consistent with safety and soundness, to encourage the flow of new capital into the industry. Finally, combinations of thrifts with underwriters and marketmakers of general corporate securities should be prohibited, both to preserve thrifts' ability to carry out their housing function, and to prevent unique risks and potential conflicts of interest which could result from such affiliations.

The Bank Board proposal carries out these goals by providing a number of complementary reforms.

1. Reaffirming the Housing Focus of FSLIC Insurance

As I stated earlier, the Bank Board believes that the most crucial goal of reform in the thrift regulatory system is the restructuring and strengthening of the FSLIC. The Board

believes it is critical for Congress to enact legislation in this area before addressing other areas related to deregulation in the financial services arena.

The key principle of such reform, in the Bank Board's view, is the basic home lending focus of the thrift regulatory structure. Largely as a result of vastly liberalized state empowerments for thrifts, the FSLIC today must underwrite risks and investments which Congress itself never contemplated when it created that structure -- investments which bear no reasonable relationship to the business of being a thrift.

As a threshold matter, the Bank Board believes that reform must provide that FSLIC insurance is appropriate only to support activities that are closely linked to the primary housing mission which Congress itself emphatically mandated when it created the FSLIC and the other components of our thrift regulatory structure, the Federal Home Loan Banks and the Board itself. Such legislation should explicitly direct that any FSLIC-insured depository could engage only in the following activities:

- (1) mortgage loans and other activities authorized to be engaged in by federal savings and loan associations;
- (2) business activities which multiple savings and loan holding companies and their subsidiaries may engage in under both the National Housing Act and regulations of the FSLIC, such as engaging in real estate development and providing credit insurance; and

(2) such other services as the FSLIC may approve as being a proper incident to the operation of insured institutions and not detrimental to the interest of savings accountholders.

This approach, in my view, is essential to preserve the integrity of the thrift regulatory structure and the unique benefits it confers to support housing lenders. At the same time, it would preserve the validity of new state powers for thrifts which are appropriate adjuncts to the home finance mission which is the cardinal underpinning of federal support for that mission.

There are some, no doubt, who will argue that this concept intrudes on the prerogatives of the states. But I believe any such argument rests on a fundamental misperception of the public policy issue involved. The issue is whether a benefit fashioned by the federal government expressly to facilitate home lending, and to sustain public confidence in home lending institutions, should be freely available to support the infinite variety of entrepreneurial activity many states have permitted for their thrift institutions.

I support the dual federal and state system for chartering thrifts. But I also support a rational system. And the dual system as it has evolved in the last several years is rapidly abandoning its claim to a rational nexus between the powers of state thrifts and the purpose of the federal network of regulatory entitlements expressly created to nurture home

financing. I believe this development is one which Congress never contemplated, and never approved, and which it must act swiftly to correct to preserve the integrity of the federal thrift regulatory framework.

As I pointed out earlier -- and I cannot overemphasize this point -- the Federal Savings and Loan Insurance Corporation was created in 1934 by the National Housing Act to insure the accounts of depositors who choose to place their funds in institutions whose principal purpose is that of providing "economical home financing." For almost half a century this goal of supporting economical home financing was nurtured in a regulatory climate which placed very narrow constraints on thrift activities, focused almost exclusively on home finance, with little flexibility to generate contracyclical income to support the mortgage loan function. The powers of federal and state thrift institutions thus closely paralleled each other for over four decades. The diversity and magnitude of risk attendant in activities unrelated to home finance simply were not significant issues, and the federal government did not contemplate those issues when it created the federal umbrella of support for home lending. So while the dual federal-state chartering system allowed some room for experimentation, there was little need or incentive for state legislatures to grant their FSLIC-insured thrift depositories significantly broader

authority in an era of rigidly controlled competition which still allowed a safe margin for profits due to deposit rate control.

Heated competition from non-regulated competitors with the advent of volatile economic conditions and deposit rate deregulation, increasing consumer awareness, and deregulation of federal thrift powers, caused some state legislatures to seek, if not run, toward far more liberal powers for their state chartered depositors. So today, many states have given thrift management far greater discretion to take on new and higher levels of risk unrelated to home finance -- and to make good or bad business decisions. In some cases, state legislatures have gone beyond, and infinitely beyond, the powers granted federal thrifts under the Garn-St Germain Act as supplements to their home lending mission. For example, by statute Arizona permits direct investments by thrifts equal to 36 percent of assets; California, 100 percent, Florida, 30 percent; Ohio, 29-36 percent; and Texas, 100 percent. By contrast, under Garn-St Germain federally-chartered thrift institutions are not now authorized to engage in this sort of real-estate development, or generally to invest in the stock market or for-profit corporations. Their service corporation investment authority is strictly limited to a maximum of three percent of their assets.

This trend by state legislatures, which has, in effect, provided a federal subsidy to direct investment activities such as stock takeovers, wind farming, and oil drilling, is clearly

at odds with the fundamental purpose of the National Housing Act and the Federal Home Loan Bank Act. Nothing since the passage of these statutes -- no subsequent action of the Congress -- has changed that fundamental purpose of support for home financing. Indeed, in 1982, when the Congress passed and the President signed into law the Garn-St Germain Depository Institution Act -- the most important piece of legislation for the savings institutions industry in a half century -- the emphasis on "economical home financing," the words themselves, were retained in the law as a fundamental public policy imperative for our federally-sponsored savings institution system.

And, as was stated earlier the preamble of the Garn-St Germain Act leaves no doubt as to the purpose of the new authorities it granted to the nation's federally-insured savings institutions.

Again, the Congress clearly outlined the additional authorities it believed were suitable for these institutions, consistent with the public policy imperatives and reaffirmations it expressed in the preamble and provisions of the Act, itself. At the same time, Congress reviewed and determined to retain as consistent with these goals the cluster of diversification options afforded multiple holding companies and their thrifts to support housing.

The statute governing multiple holding company powers establishes appropriate boundaries for diversification by FSLIC-insured home lenders through affiliation with corporate

parents, sister affiliates, and operating subsidiaries or service corporations of the thrift within the multiple holding company structure. Congress in that law determined a number of such appropriate activities, and further directed the FSLIC to permit such other powers as it might find "a proper incident to the operations of savings institutions," which are themselves federally insured to further economical home financing.

The benchmarks defining Congress' view of appropriate adjuncts to home lending which should be supported through FSLIC insurance are the powers of federally-chartered thrifts as defined by the Garn-St Germain Act and the provisions of law governing multiple thrift holding companies.

I believe the type of approach I have outlined could clarify and reinforce these Congressional decisions as to the sort of activity, and the extent of activity, suitable for thrift federal deposit insurance. It is after all the FSLIC which ultimately must bear the risk of loss incurred from activities which cause or contribute to the imminent collapse or insolvency of an insured institution, whether state-or federally-chartered.

Federally-insured savings institutions, whose principal statutory purpose is that of providing "economical home financing," are the beneficiaries of the public policy, with the established advantages of soliciting operating funds through marketing the FSLIC insurance seal of deposit protection.

Indeed, all federally-insured depository institutions enjoy that unique advantage in their solicitation of funds with which to carry out their operations.

Again, this unique advantage enables such institutions to operate, in effect, on the implicit, if not explicit, full faith and credit of the United States.

The federal deposit insurance system essentially serves, or has served, to maintain confidence in, and therefore support, our depository institutions whose fundamental purpose has been to extend credit in order to facilitate investment. Generally speaking, the role of depository institutions has not been that of making direct investments, but rather that of facilitating direct investments by other entities, by extending credit to those entities.

I raise this issue because, in all honesty, the matter is one I believe the Congress should deal with as a fundamental public policy issue.

Is it proper, is it sound public policy, does it meet the elementary tests of fairness and equity, for institutions which can raise funds using the advantages of the federal deposit insurance seal to buy and run businesses, or invest in property which may be completely unrelated to economical home financing, in direct competition with investors who do not enjoy the unique and material advantages of operating on the full faith and credit of the United States?

And, in the case of a federally-insured savings institution, is it appropriate public policy for it to have access to low, effectively government-subsidized rates on funds borrowed at varying maturities from the Federal Home Loan Bank window, and then to use those funds to invest directly in an activity which bears no relationship whatsoever to the principal reason for the existence of the institution itself, or for FSLIC insurance or for Federal Home Loan Bank credit?

Is it appropriate public policy for a FSLIC-insured institution to be able to compete for funds in the marketplace with the deposit insurance seal and borrow low-cost funds from the Federal Home Loan Banks and invest those funds directly in oil drilling operations, fast food restaurants, wind farms and all manner of other endeavors which are not remotely related to housing finance or the business of a thrift in direct competition with investors in the private marketplace that do not enjoy the advantages of attracting such funds, at such rates, to make direct investments?

Is it fair for small businessmen or private investors in your communities who don't have access to the Federal Home Loan Bank window, or a charter to attract funds using the FSLIC seal, to have to compete with those who do, when it comes to making investments totally unrelated to mortgage finance?

I believe that the underlying purpose of the FSLIC regulatory framework compels the conclusion that direct investments by FSLIC-insured institutions at least be reasonably related to the

fundamental thrift role these institutions are expected to play in our society. That is, direct investments by these FSLIC-insured institutions ought to be reasonably related to the purpose for which the National Housing Act established the FSLIC, and the Federal Home Loan Bank Act established the 12 tax-exempt Federal Home Loan Banks to fulfill their appropriate housing finance credit function.

These are important public policy issues which, it seems to me, need to be addressed by the Congress. I believe our proposed approach would provide the basis for a useful dialogue in finding an appropriate answer.

2. Reforming the FSLIC Premium Structure

S.759 would expressly permit the Bank Board to require additional contributions to the FSLIC by institutions undertaking activities of a kind or to an extent not authorized for federal thrifts. We believe this reform, in conjunction with appropriate boundaries on the operating powers of FSLIC-insured thrifts, is critical to the very viability of our deposit insurance system. As you know, the Bank Board serves as the operating head of the FSLIC, and in that regard we should be viewed as the operators of a federally-chartered insurance company.

As an insurance carrier whose resources are implicitly, if not explicitly, backed by the full faith and credit of the United States government, FSLIC was created under provisions of

the National Housing Act to ensure public confidence in thrifts which were and are meant principally to serve the needs of housing finance in America.

In its role of insurer, the FSLIC serves as a fundamental structural leg of the nation's Congressionally mandated deposit insurance system. It insures the deposits of 3,151 federally- and state-chartered thrifts.

But no insurance company which intends to maintain its viability can endure or operate successfully unless it works to maintain sufficient reserves to meet its obligations and has available the underwriting resources necessary to manage effectively the risk it is likely to incur. As you know, the current statutes of both the FSLIC and the Federal Deposit Insurance Corporation basically provide only for premiums set at a flat rate of one-twelfth of one percent of total domestic deposits. This insurance premium structure was designed to function in a regulatory climate where variation and magnitude of risk were not significant issues, and the Federal government did not contemplate those issues when it created these insurance funds. As I mentioned earlier, the statutes regulating both insured banks and thrifts historically served to minimize the risk exposure of the federal insurance funds. Strict, and roughly parallel controls on the powers of federal and state institutions are tailored to the risk activity of institutions to fit the finite resources of the insurance funds. The accelerating pace of deregulation at both the federal and state

levels has removed that built-in safety net, without providing the insurers an effective means to deal with an infinitely more volatile risk equation.

In the Board's view, the combination of an insurance system straightjacketed by a flat rate premium system which cannot account for the magnitude or diversity of risk to be incurred, and requiring the FSLIC to shoulder the enormous new risks posed by this deregulatory trend, is nothing less than a recipe for disaster. In the deregulated environment, federal deposit insurance actually encourages managers to take the biggest and riskiest gambles, to obtain the highest possible returns. It creates a "heads I win, tails FSLIC loses" situation for institutions which leverage heavily off low capital and take excessive risk. Financial gains are potentially enormous for stockholders and managers if an insured institution takes a big gamble and wins. But a federal agency, like the thrift insurance corporation the Bank Board heads, ends up picking up most of the cost if the gamble turns out a loser.

We thus have the irrational -- and I believe unsupportable -- result that the FSLIC shoulders the entire responsibility for protecting the funds of insured accountholders in state-chartered thrifts with widely varying powers, without any means of underwriting that risk effectively. And given the aggressive trend in some state legislatures, the Board is concerned that we are rapidly reaching the point where the state leg of the dual

system can become totally divorced from the fiscal consequences to the federal insurance funds -- and in the worst case, to the taxpayers of this country.

In my view, it is simply not rational to expect a single, federally-chartered insurance company with limited resources to insure the diversity and magnitude of risk inherent in the growing universe of operating powers in various states -- if that insurance company cannot apply flexible standards to underwrite appropriately its reserve structure.

The flat rate premium structure is also irrational because it acts as a cross-subsidy. It clearly imposes an unfair burden on conservative, well-managed institutions which are forced to subsidize the high flyers that crash. I believe the supplemental premium structure authorized by S.759 would address these problems, and is absolutely critical to restore the FSLIC to the level of strength it needs to sustain its crucial role of preserving public confidence in our nation's thrifts.

Under S.759, institutions which have the authority to engage in activities which go beyond those which Congress found suitable to insure for federally chartered savings institutions. Other institutions would pay supplementary premiums to the FSLIC in return for the right to engage in higher risk activities. We believe that this approach would operate in tandem with our proposed definition of appropriate powers for state-chartered thrifts to strengthen the underpinnings of the dual federal-state system. These two

reforms would interact to reaffirm the validity of housing-related state-authorized thrift powers for healthy institutions, while, at the same time, more fairly allocating the cost of risk to the FSLIC and the risk of loss to member FSLIC institutions.

I believe certain net worth standards should be met by institutions which would participate in the supplementary premium program. The quality of management and track record of the institution ought to meet certain criteria. Any thriftiness test in existence should have to be satisfied. And the extent to which an institution chose to engage in such activities would also be a determinant of the amount of the supplementary premium charged.

Another factor which would be taken into account would be the level of real net worth held by the participant in the supplementary premium program. Those institutions with very high real net worth would pay proportionately less in supplementary premiums than less well-capitalized participants, given the protection that very high net worth affords to cushion the risk of loss to both the institution and to the FSLIC.

At the beginning, experience would determine the exact pricing mechanism and a combination of either rebates or surcharges would perfect the pricing of supplementary premiums.

We believe the relative simplicity of this risk premium concept, compared to others that have been proposed, and the fact that it would be tied prospectively to risk activities rather than complex retroactively-established ratings of the relative "riskiness" of an institution, speak for themselves.

I believe the risk premium concept I have described here represents a way to infuse greater rationality into our thrift deposit insurance fund on a long-term basis.

Asset Composition Test

S.759 would create a special asset composition test as a benchmark for thrift eligibility for ownership by diversified companies, access to Federal Home Loan Bank System advances, and access by state-chartered thrifts to FSLIC deposit insurance. I believe such a test is a critical supplement to our suggested reforms to thrift deposit insurance because it reflects the reality of the distinctive marketplace functions of thrifts and banks. Such a test also affords an additional fair and practical means to assure that only those institutions with a substantial commitment to housing finance will continue to function within a framework specifically fashioned by law to aid their mission.

In my view, every thrift should be able to pursue diversification options. But if diversification entails abandoning home finance as the primary mission, an institution should not be allowed to compromise the purpose of the separate thrift

regulatory structure by freely availing itself of that structure's financial benefits. An appropriate asset test would resolve this problem by denying future bank-like thrifts the benefits which should be preserved exclusively for institutions dedicated principally to housing finance and housing-related investments.

At the same time, such a test would reaffirm the intent of the Garn-St Germain Act "to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and insuring the availability of mortgage loans".

I believe the asset composition test included in S.759 will insure a significant and continuing emphasis on home finance by those lenders which seek the benefits of the unique home finance regulatory framework. Under the test, a "qualified thrift lender" would have to maintain at least 60 percent of assets in specific housing and housing-related investments and certain liquid assets. An institution which failed to maintain that status would be ineligible to regain it for a period of five years.

While the current "thriftiness" test established by Section 7701 of the Internal Revenue Code and used to establish eligibility for unitary ownership by the Garn-St Germain Act serves as the guidepost for the test in S.759, the test would also include certain new qualifying assets we believe vital to allow flexibility to thrift managements to develop their own housing focus, and which are consistent to a large degree with the

provisions of S.2851 passed by the Senate last year. These would include liquid assets qualified under Section 5A of the Federal Home Loan Bank Act, loans, equity positions or securities related to residential real estate, investments in mortgage-related securities, and investment in all shelter providing facilities such as nursing homes and student dormitories. Because S.759 would afford the FSLIC broad authority to interpret and regulate regarding the qualifying asset test, the Bank Board could address any potential misuse of this "laundry list" -- such as excessive concentration in liquidity items -- by imposing limits on particular types of investments.

The Bank Board is firmly convinced, in particular, that the liquid assets included in this definition are a crucial component of any thriftiness test. Maximum flexibility in this regard is absolutely vital to allow a thrift to manage liquidity effectively in volatile economic conditions, and make investments closely related to its home finance function. The Federal Home Loan Bank Act already requires its members to hold such liquid investments at a level between four percent and ten percent as determined by Bank Board regulations.

S.759 would also authorize the Bank Board to accord some level of credit to thrifts which support housing through originating loans and selling them in the secondary market, while generating servicing fee income. Thrifts which have a substantial portfolio investment in home loans as well as significant secondary market activity should not be arbitrarily

deprived of qualified status. This flexibility will also aid managers to cope more effectively with changing economic conditions which may dictate higher levels of secondary market activity as a means of offsetting loans arising from maturity mismatches which are a continuing threat to the thrift industry.

S.759 would also provide for a qualifying averaging period of three out of five years. This differs slightly from the Senate-passed bill, which would have provided for a qualified averaging period of two out of three years. We believe that this longer qualifying averaging concept is more appropriate given the vagaries of housing demand and the sensitivity of the industry to rate swings. The three out of five year concept is also a crucial supplement to the liquidity and secondary market provisions of S.759, and would further aid institutions in dealing with volatile conditions in a rapidly changing marketplace without the penalty of disruptive changes to holding company activities or constraint on access to Federal Home Loan Bank advances.

As an additional means of preserving the benefits of the thrift regulatory structure and deposit insurance that the thrift system remains as the source of support and strength for home finance.

Finally, S.759's "thriftiness" concept would appropriately enhance the attractiveness of a federal thrift charter by increasing the service corporation investment authority of

federals which meet the test, by increasing the authorized level of investment therein from three to five percent of assets of federal qualified thrift lenders.

Investment Banking

I would like, briefly, to address the issue of the merger of investment banking -- that is, securities underwriting -- with depository banking. I am not referring here to stock brokerage but rather stock underwriting. The combination of investment and depository banking has been recognized, over the years, as presenting unique potential for conflicts of interest and risk. As the Supreme Court pointed out over a decade ago, the competition, convenience, and expertise which might otherwise support the combination of depository and investment banking activities, were outweighed by the hazards and financial dangers that arise when depository institutions combine with investment banking firms.

The Bank Board believes that a strict wall between investment banking activities and deposit-taking should be preserved. In that regard, Bank the Board believes that depository institutions and their affiliates should be prohibited from underwriting or market-making corporate equity or debt securities.

The Bank Board's legislative proposal in the 99th Congress contains a provision which narrowly targets those types of activities or affiliations which threaten the integrity of FSLIC insurance and thrifts' ability to carry out their preeminent home

home finance function. In that regard, S. 759 prohibits savings and loan holding companies and FSLIC-insured institutions, regardless of whether or not they are controlled by a holding company, from directly or indirectly engaging in activities of an underwriter or marketmaker in equity securities or debt securities, other than those secured by interests in real estate or that are eligible to be underwritten by national banks. This approach preserves those affiliations that are appropriate to home lending.

Brokered Funds

S. 759 would permit the Bank Board to establish classes of insured accounts and to insure only those classes appropriate for insurance by a federal agency; deposits that are in reality equity investments, and those structured to place excess risk on the FSLIC, would not be federally insured. We believe this enhancement of our existing statutory authority under the National Housing Act would further strengthen the FSLIC and preserve the integrity of the thrift regulatory structure. By providing such authority, the bill would insure the Bank Board the authority to prevent the diversion of deposit insurance resources to activities such as deposit brokering. The high degree of risk associated with brokered deposits -- both because such funds tend to move quickly in and out of institutions, and

because the high rates needed to attract them may encourage institutions to undertake unduly risky ventures -- in my view requires restricting insurance coverage on these deposits.

Enforcement and Supervision

In the challenging deregulated environment we confront as regulators, it has become increasingly clear that new tools are vital to effectively empower the Bank Board to monitor risk-taking and avert substantial losses to the FSLIC fund by taking appropriate supervisory action before unsound practices have forced an institution into insolvency. S.759 would provide a number of strengthened enforcement tools designed to husband more effectively the FSLIC's resources. At present, the Bank Board often cannot take enforcement actions or identify negligent individuals until it may be too late to save an institution. The new powers granted by S.759 will permit the Bank Board to act early enough to preserve the financial soundness of as many troubled institutions as possible, and to reduce losses to the FSLIC. The bill would, for example, clarify the Bank Board's authority to act against a negligent thrift officer who resigns just prior to an enforcement action's being brought against him. It would also give the Bank Board the ability to act quickly when an institution's books and records are so incomplete or inaccurate that its true financial condition is unknown.

Effective FSLIC Management

S. 759 would also enact a number of changes to enhance the ability of the FSLIC to carry out its receivership and assistance duties more efficiently. For example, the bill would insure the FSLIC greater flexibility to marshal sufficient resources to deal with the escalating supervisory caseload which has resulted from deregulation. We believe this authority is critical to ensure the most efficient use of the FSLIC's resources at a time when liquidations have dramatically increased. We have requested the support of OMB for our efforts to obtain the necessary Congressional approval for legislation to provide this flexibility to the FSLIC by removing our FSLIC nonadministrative employees from the appropriations process.

S. 759 also would increase the efficiency of the receivership process, and complement the FSLIC's enhanced budget flexibility, by making a number of changes to our statutes to afford the FSLIC powers to marshal the assets of a failed institution, and to make an equitable distribution, paralleling those provided trustees under federal bankruptcy law. It would clarify the receiver's right to assume the position of lien creditor, bona fide purchaser, or equity receiver against transferees of an institution's property, and would put the Corporation on an equal footing with the FDIC by invalidating improper "side deals" tending to defeat the interests of the Corporation as receiver. The bill further provides for an automatic stay on claims against the receivership estate analogous to that

provided under the Bankruptcy Code. The automatic stay would not operate against some claims, including the secured claims of the Federal Home Loan Banks or the liquidation rights of a "repo participant" under a repurchase agreement. Finally, the bill would specify the priorities of unsecured claims against the receivership estate and, as to be revised by amendments we will shortly submit, would give the Corporation priority over the general creditors of an institution to the extent of insurance payments to account holders of the institution. If these revisions are enacted, we believe substantial reductions in costs and the time needed for liquidations would result.

Conclusion

I look forward to working closely with the members of this Committee to shore up the financial resources of the FSLIC and to improve the thrift industry's prospects for negotiating today's fragile transition toward renewed strength. Nothing is more important in that process than the continued support and confidence of you, the members of Congress. There are no panaceas. No single measure will suffice. The solution lies in a mosaic of necessary decisions which must be made -- the kind of decisions which are incorporated in our legislative proposal.

I will be pleased to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Chairman. First of all, let me make a request of you. Last week, Senator Riegle brought up the issue, and rightfully so, of discussing the reasons for failures of banking institutions. Although the bill that passed the Senate last year has very little to do with thrifts—we are not granting additional powers for the thrifts or further deregulation of the thrift industry in the proposal that passed the Senate last year—I think it would be helpful if you could supply us with, as Chairman Isaac has said he would do, an analysis of the reasons for failures of institutions and a list of troubled institutions. Obviously you can't go through them individually, but we'd like to know what you think the prospects are as far as those particular institutions are concerned so we can get a sense of the reasons for the difficulties.

[Information requested was subsequently submitted for the record as follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
CHAIRMAN GRAY

Question 1: Please provide the Committee with an analysis of thrift failures and a forecast of the prospects for those institutions which are currently on the troubled list.

Answer:

We have defined thrift failures as those thrifts which were deemed to be insolvent or otherwise in an unsafe or unsound condition to do business. As a consequence of their failure, the institutions were deemed to have required FSLIC assistance. Potential failures are those cases which are forecasted to need assistance within the next 12 months (from June 1, 1985 to May 31, 1986) based on our financial analysis.

An analysis of failures demonstrates a substantial shift in the primary causes of thrift failures from 1983 to the present (YTD June 1985). In 1983, thrift failures were primarily attributed to interest rate spread problems. Sixty-nine percent of 1983 failures were spread related versus 31 percent caused by poor asset quality. During 1984, a disturbing trend began to emerge with a complete reversal from 1983 results. The causes of thrift failures in 1984 which were the result of asset quality problems represented 70 percent of total failures, with spread problems representing 30 percent. Already in 1985, all 17 FSLIC failures have been directly attributed to asset quality, with no significant spread problems noted.

Coupled with the increase in asset related problems, was a significant increase in the cost of resolving failures. In 1984, asset related failures resulted in assistance of 27 percent of total assets of the failed thrifts, compared to 3 percent for spread related failures.

A forecast of troubled institutions, reaffirms that this asset quality failure trend is continuing. While the Federal Home Loan Bank Board does not maintain a "troubled list," our Supervisory Agents at the Federal Home Loan Banks, the Office of Examinations and Supervision and the Office of the Federal Savings and Loan Insurance Corporation have targeted specific institutions which meet the potential failure criterion defined above. Such institutions are classified as "Current FSLIC Cases", "Current Phoenixes", "FSLIC Assistance Cases within Six Months", and "FSLIC Assistance Cases Requiring Assistance from 6-12 Months". Currently 117 institutions meet these criteria. Of these cases, asset problems account for 74% of potential failures.

The recent trend in rapid growth and direct investments have resulted in unsound investment in speculative assets. Our experience in California and Texas suggests the increase in FSLIC thrift failures and the potential for additional failures within the next 12 months. The pressure on FSLIC resources has been increased significantly, far more than those presented by spread problems in the past. We have concluded that rapid expansion increases risk and the potential for loss.

As I reported on May 14th, the Federal Home Loan Bank Board took action to stem the tide of this movement by (1) bolstering the capital requirements for those institutions which choose to grow quickly; thus creating an additional safety buffer to FSLIC, and one which is provided by the institution itself, and (2) increased oversight of direct equity investments. In addition, we attacked unsound and unsafe growth in 1984 by placing restraints on brokered savings for those institutions without adequate capital.

Since June of 1984, in response to my directive, our Federal Home Loan Banks have significantly increased supervisory professional staffs to deal with the increase in problems. OMB constraints resulted in a reduction of our authorized examiner levels by 6% in 1984 from 981 for FY 1983 to 875 for FY 1984. Authorized Federal examination staff levels were only increased by 3% from 1984 to 1985. However, we anticipate that the transfer of federal examiners to the Federal Home Loan Banks should allow for substantial staff increases. Additional staffing will provide improved follow-up and caseload management.

These steps will reduce the potential for additional problems and will afford us an opportunity to effectively deal with those thrifts projected to fail within the next 12 months. The number of actual and potential failures in California and Texas has resulted in discussions to substantially limit direct investment authority of state-chartered institutions and efforts to encourage state supervisory authorities to increase their examination and professional staffs.

In addition, we expect that the Garn-St Germain Depository Institutions Act will not sunset in October 1985 with respect to Net Worth Certificates. With liberalization of the Net Worth Certificate rules, we expect that FSLIC will purchase an additional \$180 million in such certificates during 1985.

Finally, our Supervisory Agents at the Federal Home Loan Banks have been encouraged to pursue management contracts for failed institutions. The management contracts negotiated to date have generally involved a well managed institution providing management services to a failed institution. The management contract tool affords us an opportunity to restore depositor confidence, gain time to assess FSLIC insurance exposure, maintain continuity of operations, and most importantly, the potential for minimizing the amount of FSLIC assistance necessary to resolve a failure.

Question 2:

Please provide the Committee with statistics on the extent of junk bond holdings by insured savings and loans.

Answer:

The Board does not have precise statistics on the extent of junk bond holdings by FSLIC-insured institutions. It did conduct a small survey of large institutions, and, on the basis of that survey, the Board believes that junk bond holdings of FSLIC-insured institutions are about \$5 billion. Over half this total is held by a relatively small number of institutions.

Question 3: In your testimony, you criticized states' ability to charter and examine savings and loans. What criteria should be used to evaluate state supervisors? Specifically, what product and service authorities in what states trouble you?

Answer:Evaluation of State Supervisors

We believe that the criteria used to evaluate state supervisory authorities are inherently the responsibility of state authorities and their respective legislative bodies. However, we do suggest that criteria similar to those used by the Federal Home Loan Bank Board should be developed and implemented by State supervisory authorities. Relevant criteria are those which relate to the examination process, examination monitoring, supervisory monitoring, and the processing of various applications. In addition, efforts to resolve supervisory problems without the necessity of FSLIC assistance are highly desirable. On an annual basis, the FHLBB performs evaluations of Washington staff responsible for examination oversight and application processing. In addition, Washington staff performs annual evaluations of the performance of our Supervisory Agents in the Federal Home Loan Banks.

The purpose of our evaluation process is to review supervisory monitoring efforts, timeliness of supervisory action, ability to identify and resolve problem situations, ability to minimize the cost to the FSLIC in seeking solutions to institutions which are failures, and the ability to interact favorably with the various components in the supervisory process.

One significant area which we believe merits the attention of state supervisory authorities relates to the need for possible increases in state supervisory staffs. Our own experience over the past 24 months has resulted in significant Federal Home Loan Bank supervisory staff increases, with more still to come. In view of the increase during 1984 in the number of FSLIC-insured institutions which were deemed failures, the number of newly-chartered institutions, the shift from spread-related to asset-related problems, and the diversity of thrift activities as a consequence of deregulation, the FHLBB sought to increase the number of Federal Home Loan Bank Board professional supervisory staff (Monitoring and Application Departments). In June 1984, the FHLBB directed an immediate increase in our supervisory staffs located in the Federal Home Loan Banks. During the past year,

June 1984 through June 1985, our Supervisory Agents have significantly increased their supervisory staffs in direct response to the June 1984 directive to increase staffing levels. Federal Home Loan Bank supervisory staff size increased from 157 nationwide at May 31, 1984, to 301 as of June 21, 1985. Twenty-three additional staff members are planned. Exhibit 2 displays the results of efforts taken to increase staffing levels.

Efforts have been made to increase Federal examiner levels. However, there has been extraordinary staff turnover, and we have been faced with OPM staffing constraints (Exhibit 1). However, we anticipate that the transfer of the Federal examiners to the Federal Home Loan Banks which occurred in early July should allow for significant staff increases in the examiner ranks. Salaries should become more competitive for lower level examiners, specialists can be hired, the Banks will be free of OPM staffing constraints, and more favorable travel guidelines can be adopted.

The FHLBB has no control over state supervisory staffing levels. However, we believe that state supervisory efforts should be directed towards increasing examiner levels in areas where the number of actual and potential FSLIC failures is greatest.

We believe that the number of current and anticipated FSLIC cases within Texas, California, and Florida warrants an increase in state supervisory staffs. Secondly, we find a relationship between state chartered problem cases in these states and the broader powers allowed the state chartered thrifts. For instance, California currently has eight institutions which will require FSLIC assistance with total assets of \$10.1 billion. Seven institutions with assets of \$1.5 billion are projected to become failures within the next twelve months. Ten of these fifteen institutions are state chartered with total assets of \$8.5 billion. Texas has two current failures with assets of \$600 million. Ten institutions with total assets of \$3.8 billion are projected to require assistance within the next twelve months. All the Texas institutions cited are state chartered. Two state chartered Florida institutions with assets totaling \$1.7 billion are projected to become failures within the next 12 months.

In each of the aforementioned states, broader state charter authority has given rise to an increased likelihood of failure.

For example, in 1983, California totally deregulated the asset powers of state-chartered thrifts. California institutions are allowed to invest 100% in real estate. In addition, 100% of assets can be invested in a service corporation. California state-chartered thrifts have significant problems: investments noted include windmill farms, hamburger stands, significant investments in "junk" bonds, corporate securities and equity securities, and real estate development projects.

Junk bonds in the past were primarily made up of bonds from formerly top rated companies which had fallen temporarily on hard times. However, the trend has recently shifted towards low rated companies issuing junk-bonds right from the start. The newer junk bonds are concentrated in two areas: (1) risky newer companies, and (2) financing of risky corporate takeovers. Junk bonds represent increased investment risk. Concentration in riskier investments is potentially unsafe and unsound.

Texas also has legislated broad investment powers to state chartered thrifts that include: (1) powers to make land development loans, (2) powers to invest in corporate bonds and securities, (3) broad service corporation investment authority, and (4) broad powers to acquire, subdivide and develop real property for residential and other purposes.

Specific product and service authorities allowed state-chartered institutions in Florida, which have caused supervisory problems or, in our opinion, have the potential to cause supervisory problems include: (1) Up to 20% of total assets may be invested in stock, obligations, or other securities of service corporations or other corporations or entities. (2) Up to the lesser of the amount of net worth or 10% of assets may be invested in real estate. (3) A provision in the state's regulations requires that securities must be rated Baa, BAA or higher, unless otherwise supported as to investment quality and marketability by a credit rating file compiled and maintained in current status by the purchasing association. This provision has effectively allowed substantial investment in "junk" bonds. For example, a Miami thrift has 20% of its assets in "junk" bonds at March 31, 1985. Also, certain institutions' investment in the obligations of other companies have had "greenmail" connotations either by the institutions themselves or by the companies in which they were purchasing securities. Purchasers of substantial investments in other companies has also subjected the Miami institution to lawsuits resulting in substantial expenditures of time and money.

In summary, many states have granted product and service authorities which exceed those allowed federally chartered thrifts. Direct investment and service corporation investment levels are generally higher than those allowed federal institutions.

Attachments:

- Exhibit 1 - Number of Full-Time Equivalent Examiners in PHLBB.
- Exhibit 2 - Increases in PHLBB Professional Supervisory Staff Size.
- Exhibit 3 - Letter from Chairman Gray to Mr. R.J. McMahon, Commissioner, Office of Savings and Loan, Wisconsin.

Number of Full-Time Equivalent (FTE) Examiners

Districts	As of June 1984		As of June 1985	
	6/23/84 No. of Authorized	6/23/84 Examiners on Board	6/22/85 No. of Authorized	6/22/85 Examiners on Board
401 Boston	31	33	31	31
402 New York	78	72	78	75
403 Pittsburgh	53	51	53	50
404 Atlanta	129	121	135	121
405 Cincinnati	90	90	90	89
406 Indianapolis	40	40	40	39
407 Chicago	90	88	93	90
408 Des Moines	59	58	59	58
409 Dallas	127	122	134	137
410 Topeka	43	40	43	42
411 San Francisco	97	96	102	108
412 Seattle	38	38	39	41
	====	====	====	====
Total	875	849	897	881

Footnote: The above figures represent total field examination-related employment and in addition to examiners, include district directors and other examination field offices' overhead personnel. The percentage of examiners to total field employment is approximately 84%.

EXHIBIT 2

INCREASES IN FBI PROFESSIONAL SUPERVISORY STAFF SIZE

DISTRICT	BEGINNING	STAFF ADDED DURING QUARTER ENDING					TOTAL	PLANNED
	BALANCE	6/84	9/84	12/84	3/85	6/21/85	6/21/85	ADDITIONS
BOSTON	7	1	2	4	3	1	18	1
NEW YORK	9	2	2	3	1	0	17	3 TO 6
PITTSBURGH	8	1	1	2	-1	0	11	3
ATLANTA	21	9	3	0	0	11	44	2
CINCINNATI	7	4	3	0	1	2	17	0
INDIANAPOLIS	4	3	2	1	0	2	12	1
CHICAGO	14	3	8	2	-1	0	26	2
DES MOINES	9	2	0	1	1	0	13	1
DALLAS	32	7	3	5	9	0	56	11 (estimate)
TOPEKA	6	1	4	0	0	0	11	0
SAN FRANCISCO	36	3	4	2	3	15	63	12
SEATTLE	4	4	2	2	1	0	13	1
TOTALS	157	40	34	22	17	31	301	23

EXHIBIT 3

Federal Home Loan Bank Board



1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

EDWIN J. GRAY
CHAIRMAN

June 11, 1985

Mr. R. J. McMahon
Commissioner
Office of Commissioner of
Savings and Loan
Suite 502
1313 West Wilson Street
Madison, Wisconsin 53702

Dear Commissioner McMahon:

It is indeed unfortunate that you read into my remarks as published in the Savings and Loan Reporter a criticism of you and your staff or any other state savings and loan commissioner and his or her staff.

I did not mean to suggest that members of any such staff are less than fully dedicated and competent. Rather, I was suggesting that state savings and loan departments, at least generally, are suffering from the same lack of personnel resources as the Bank Board. I have made it clear in testimony before the Congress on a number of occasions this year that we are short of adequate staff resources to examine institutions. If this is not the case in Wisconsin, if you have no need for additional examination and supervision resources to accomplish your tasks, I stand corrected, in your case.

I have indeed heard from some state commissioners, and I have looked at the numbers for certain states, indicating that examination and supervision resources are inadequate. Again, I am not referring to quality, but rather quantity, that is to say the number of personnel needed to examine and supervise institutions.

As you know, the Bank Board has made a decision to transfer field examination staff to the Federal Home Loan Bank districts in order to remove hiring and salary constraints. We are determined to build an examination and supervision force quickly which will have no peer in the Federal system. After all, examination and supervision constitute the first line of defense for safety and soundness, both at the level of the institution and for the FSLIC.

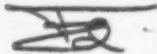
Finally, your reference to the "seemingly disjointed responses and comments" I made in a very lengthy interview with the Savings and Loan Reporter apparently did not take into account the editing down of the interview.

In my view, state legislatures and governors must come to terms with the growing need for adequate examination and supervision resources -- that is to say adequate numbers of examiners and supervisors -- so that the dual state-federal thrift system can truly function effectively and fully satisfy the safety and soundness imperatives of today's far more complex and demanding deregulated operating environment.

If my comments serve to focus greater attention on this issue, then I believe they will have served a useful purpose. After all, savings institutions, themselves, underwrite the cost of examination and supervision generally, not state fiscal budgets and not state or federal tax resources.

Finally, I hope you agree with me that states which choose to charter and regulate their own state-chartered institutions should meet the federal government at least half way in providing adequate staffing levels for supervision and examination in order to accomplish the safety and soundness goals we jointly seek.

Sincerely,



Edwin J. Gray

cc: Donald Hovde
Mary A. Grigsby
U.S. Senator William Proxmire
U.S. Senator Robert Kasten, Jr.
U.S. Congressman Gerald Kleczka
U.S. Congressman David Obey
U.S. Congressman Les Aspin
William S. Bergman, Executive Vice President, NASCLS
Texas Commissioner, L. L. Bowman, III
North Carolina Commissioner George King
William D. Brouse, President, Wis. League of Financial
Institutions, Ltd.
Gerald J. Levy, President, Guaranty S&L
Andrew Mandella, Savings & Loan Reporter

Question 4:

In your opinion what test would be appropriate in determining a qualified thrift lender? What should be included and why?

Answer:

Mortgages, mortgage-backed securities, Treasury securities, agency securities, "eligible" liquid assets, cash, general obligation state and municipal issues, educational loans, fixed-assets, and loans secured by deposits. The Board has proposed that at least sixty percent of a thrift's assets be in the enumerated categories in order to satisfy the qualified thrift lender test. In addition, special consideration must be given to those institutions that originate but sell a large volume of new mortgages.

A qualified thrift test of this nature will help to keep the savings and loan industry firmly performing its unique housing function and to ensure the availability of mortgage loans.

Question 5: Currently savings and loans are permitted to engage in insurance underwriting and brokerage through their service corporations. Have these services provided any benefits to the consumer? To the savings and loans? Have any problems developed with regard to this authority?

Answer:

Background

Thrifts currently are permitted to engage in various types of brokerage or agency business through service corporations. Thrifts cannot directly engage in insurance related activities. However, service corporations have broad authorities set forth in Section 545.74. The following activities are specifically approved for federal thrifts: insurance brokerage or agency for liability, casualty, automobile, life, health, accident, and title insurance (Section 545.74(5)(ii)). Private mortgage insurance is specifically excluded.

Between 1983 and 1985 the FHLBB approved several service corporation insurance applications which were generally not related to the extension of credit: life insurance on borrowers and savers which is non-credit related. However, a recent Office of General Counsel opinion dated April 30, 1985, has held that non-credit related insurance activities are not permitted (Exhibit 1).

For state-chartered institutions, insurance activities are governed by the state charter held by the thrift and state laws governing insurance company operations. Laws vary state to state. Most states permit state-chartered thrifts to engage in insurance related activities, however, 17 states have limiting provisions on such activities. Several states have given state thrifts the authority to underwrite life insurance on borrowers and savers. Insured institutions currently have 6,493 service corporations of which 785 are authorized to engage in insurance related activities (Exhibit 2). This represents nearly 12.1 percent of all authorized service corporation activities.

Of these 785 service corporations, 302 deal solely in insurance activities. During 1984, their parent companies increased their capital contributions by \$53.8 million, versus \$2.8 the previous year. It appears that this increase in investment has been fueled by the profitability of insurance activities. During 1983, sole-purpose insurance subsidiaries reported net income of \$4.2 million, representing a 12% return on average equity. Net income for 1984 increased to \$10.1 million on insurance commissions of \$44.1 million, representing an increased return of 13% on average equity.

Benefits to the Savings and Loan

Thrifts can use insurance service corporations to expand competitive and profit-center potential on a vertical basis.

Market studies have indicated that thrifts have excellent opportunities for insurance related activities which can be exploited with a minimal capital outlay:

- Thrifts offer services which are strongly linked to insurance offerings, especially credit-related insurance policies.
- Thrifts have an excellent customer base which is ideally structured to generate insurance related sales.
- Competition from retailers (K-Mart, Sears, Penny's), insurance companies, and financial service companies indicates consumer willingness for one-stop financial services. If thrifts are to remain competitive, they must diversify into other areas in order to create new profit centers.

Return on investment potential significant. Relatively low capital requirements, fairly reasonable ROI, and predictability of profits. For example, industry sources indicate that more than \$100,000 in annual profits can be generated by an agency with one or more employees handling traditional retail lines such as life, automobile, and homeowners insurance. (Capital requirements are minimal.)

Insurance operations can serve as a starting point for more diversified lines of business:

- Low capital requirement.
- Ability to use many of the same employees.
- Basis for launching other services.

Competitive edge over commercial banks, which have been limited with regard to their ability to deal in the sale of non-credit insurance products except in towns of less than 5,000 people, or the bank holding company has less than \$50 million in assets, or the insurance activity was grandfathered prior to May 1982.

Ease of entry into insurance activities:

- Purchasing an existing agency.
- Creating a corporate insurance subsidiary.
- Licensing requirements relatively easy.

Consumer perceptions: Market research has demonstrated that consumers have a higher regard for depository institutions rather than insurance agencies. Market studies indicate a greater "trust" factor for financial institutions than many other business activities.

Consumer Benefits

Consumer benefits can be categorized as follows:

Consumers benefit by the availability of insurance services in connection with one-stop financial shopping. They are provided with a wider variety of insurance products and additional convenience.

Consumers drove in large part deregulation of interest rates by their investment of billions of dollars in money market funds in the late 1970s and early 1980s. One could infer that the consumer would favor the continued vertical integration of additional financial services; in this case, insurance services within the thrift industry. Consumer trust of financial institutions is significantly higher than other financial service companies.

Problems

A recent survey of FHLRB examination and supervisory personnel has not revealed any significant problems with regard to insurance related activities. That is not to say that the potential for problems does not exist:

Possibility of disputes over insurance claims.

Unscrupulous behavior on the part of an employee, e.g., coercion applied to tie in sales.

Lower return for property and casualty areas because of stiff price competition.

To the extent permitted by grandfathered activities, higher risks associated with property and casualty areas.

Adverse publicity from misleading and strong-arm solicitations for insurance.

Attachments:

Exhibit 1 - OGC Opinion dated April 30, 1985.

Exhibit 2 - Service Corporation Activity Report.

Exhibit 1

Federal
Home Loan
Bank
Board

Memo

INTER-OFFICE COMMUNICATION

FROM : Corporate and Securities
Division
Office of General Counsel

DATE April 30, 1985

TO Office of District Banks

SUBJECT: Service Corporation
Application of:

[REDACTED]
Docket No. [REDACTED]

to

Underwrite credit-
related and non-credi-
related insurance

LEGAL OPINION

I. ISSUE PRESENTED

The subject application raises the issue of whether the underwriting of certain credit-related insurance products and other non-credit-related insurance products, accident, death and dismemberment and hospital indemnity insurance and annuities, may be approved as permissible activities for a service corporation of a federal association.

II. CONCLUSION

In our opinion, for the reasons discussed below, the Board has the legal authority under the regulatory "reasonably related" criterion in 12 C.F.R. § 545.74(c) to (i) deny the annuity portion of the application; (ii) grant a limited, conditional approval to the accidental death and dismemberment insurance and the hospital indemnity insurance portions, subject to the requirements that the insurance is either directly related to extensions of credit by Cragin or a service corporation thereof or that the insurance is offered only to borrowers and savers of [REDACTED] or a service corporation thereof; and (iii) approve, with standard conditions, the mortgage life insurance and mortgage disability income insurance portions.

III. FACTS

A. The Proposal

████████ Federal Savings and Loan Association ("████████") proposes to form and invest in a wholly owned first-tier service corporation that would directly underwrite the following five types of insurance:

- a. Mortgage life insurance - decreasing term insurance coverage designed to pay off the outstanding indebtedness of mortgagors in the event of death.
- b. Mortgage disability income insurance - monthly disability income designed to pay the monthly mortgage payment of mortgagors in the event of accident or sickness which causes total disability.
- c. Accidental death and dismemberment insurance - group insurance with payments to a named beneficiary upon accidental death or dismemberment of the insured.
- d. Hospital indemnity insurance - a group daily in-hospital fixed benefit per-diem plan.
- e. Single premium deferred annuities - a tax deferred savings vehicle for the customer seeking a long term investment product which does not generate currently taxable investment income to the investor. ^{1/}

Thus, ██████ proposes to underwrite two types of credit-related insurance, mortgage life insurance and mortgage disability income insurance; and three types of non-credit-related insurance, accidental death and dismemberment insurance, hospital indemnity insurance and annuities.

^{1/} The annuity would be a contract between the proposed service corporation insurance company and the policy holder ("annuitant") under which the annuitant would pay the insurance company a single premium by a minimum cash deposit of \$5,000 and the insurance company would, inter alia, guarantee (i) a minimum interest rate on the deposited funds and (ii) payouts under the settlement option chosen by the annuitant. Two of the available settlement options would involve payment, after the annuity's maturity date, either of a guaranteed lump sum representing the annuity principal and its accumulated interest or payment of a guaranteed monthly lifetime income. The annuity contract would provide for tax deferral (postponement of federal and state income taxes) on all interest not withdrawn before the annuity's maturity date. Interest on annuities would be calculated on a compounded basis.

- 3 -

██████ service corporation insurance underwriter would reinsure its liability under individual mortgage life insurance policies for benefits exceeding \$10,000 per policy with a "major independent reinsurer," i.e., the service corporation would retain a risk exposure of \$10,000 per mortgage life insurance policy with the remaining liability per policy being reinsured with a reinsurance company. Reinsurance would not be sought for mortgage disability income insurance, hospital indemnity insurance or for the payment of annuities.

With respect to accidental death and dismemberment insurance, the service corporation's liability for benefits under the policy would be restricted to fixed amounts for death or dismemberment resulting from covered accidental means and would not exceed \$100,000 per policy. As with mortgage life, the service corporation would reinsure its liability for benefits exceeding \$10,000 under any policy.

██████ indicates that its "customers" would be solicited to purchase the above-mentioned five types of insurance and defines "customers" to include its mortgage loan clients, its savers, its "transaction clients" and its "other service account clients." As discussed below, most previous approvals have defined customers as "borrowers and savers" of the parent federal association and its subsidiaries.

IV. LEGAL ANALYSIS

A. Previous Approvals

The Board previously has approved service corporation applications only for the underwriting/reinsurance of what is generally referred to as "credit-related" insurance. Approvals include credit-related life insurance, credit-related health, and accident insurance, and credit-related disability insurance.^{2/} The Board recently denied applications (1) to reinsure group life and health insurance that would be offered to employees of the applicant

^{2/} Direct Underwriting: Board Resolution Nos.

84-239, May 15, 1984; 84-76, February 6, 1984; and 81-316, June 4, 1981.

Reinsurance: Board Resolution Nos.

85-237, March 29, 1985; 85-236, March 29, 1985; 85-159, March 7, 1985; 84-714, December 7, 1984; 84-420, August 10, 1984; 84-353, June 29, 1984; 84-234, May 14, 1984; 83-544, September 26, 1983; 83-449, August 12, 1983; 83-432, August 8, 1983; 83-402, July 28, 1983; 82-484, July 15, 1982; 82-365, May 20, 1982; 81-674, November 12, 1981; and 81-392, July 9, 1981.

federal association and its subsidiaries^{3/} and (ii) to reinsure term life, whole life and universal life insurance and to issue and sell annuities.^{4/} With respect to the latter activity, the subject application represents the second proposal for a service corporation to offer annuities.

The Board previously has approved mortgage life insurance and mortgage disability income insurance underwriting comparable to that for which approval is sought by the applicant. We note further that accidental death and dismemberment insurance and hospital indemnity insurance appear to be specific categories of the general health and accident and disability insurance that has previously been approved where connected to extensions of credit and, thus, would not constitute an expansion of prior Board approvals.

Approval of that part of the proposal to sell annuities would represent an expansion of past Board action. In this regard, it is pertinent to note, as the Board is aware, that the report of the Congressional conference committee accompanying the Garn-St Germain Depository Institutions Act of 1982 contained language stating the committee's intent that the Board "should not approve . . . any new regulation expanding [the] activities of service corporations" without specific Congressional approval. Conference Report to Accompany H.R. 6267, H.R. Rep. No. 97-899, 97th Cong., 2d Sess. (1982) at 88. While such a statement by a Congressional committee is not a binding directive to the Board, it does raise a policy concern for the Board in the context of the present application. Although approval of the application would not constitute approval of a new "regulation," the activity in question goes beyond the previously approved by the Board. Thus, Board approval of this aspect of the application might be characterized as inconsistent with the spirit of the conference committee directive. In our opinion, this is a factor that the Board properly may consider as a basis for denial of the annuity portion of the subject application.

2. Limitations On Type of Insurance and Customer Base

The subject application points up the existence of some confusion regard the scope of the Board's prior approvals in the insurance area and in fact presents a valuable opportunity for the Board to clarify its position in this area. Most Board approvals in the insurance area have been conditioned upon offering the insurance activities only to "borrowers and savers" or to

^{3/} Board Resolution No. 85-237, March 29, 1985, Application by [redacted] FS&LA, [redacted], [redacted]

^{4/} Board Resolution No. 85-236, March 29, 1985, Application by [redacted] FS&LA, [redacted], [redacted]

- 5 -

"borrowers and accountholders" of the applicant federal association.^{5/} In addition, as noted above, the Board has approved applications to underwrite/reinsure only "credit-related" types of insurance or has imposed a condition limiting its approval to "credit-related" insurance products.

The key questions -- and area of confusion -- arise with respect to whether the Board has intended to restrict approvals to situations where the source of credit is the applicant federal association, perhaps including its subsidiaries, with the applicant's borrowers being the only parties that could obtain the insurance. Alternatively, the Board's prior decisions also could be read to permit parties who obtain credit from sources other than the applicant federal association or its subsidiaries to purchase insurance from the applicant. For example, it would follow that the "borrowers and savers" limitation of the "customer-only" condition was intended to restrict the sale of insurance to those types of customers of the applicant association and its subsidiaries, and, by so doing, implicitly also to restrict the source of credit to which the insurance relates to credit extended by the applicant association and its subsidiaries. However, the "borrowers and savers" limitation, while suggesting a separation of the credit from the insurance activities and restricting those parties eligible to obtain insurance,^{6/} contains no express restriction on the source of credit.

The chart set forth below illustrates the potential scope of the insurance type and customer base elements of this issue:

<u>Insurance Type</u>	<u>Customer Base</u>
1. Related to extensions of credit by the applicant association or of its service corporation.	1. Borrowers of the applicant association.
2. Related to extensions of credit by other savings and loan associations or service corporations	2. Accountholders or savers of the applicant association.
	3. Any other types of customers of the applicant

^{5/} Three of a total of eighteen Board approvals restricted insurance activities to "borrowers" of the applicant federal association and its subsidiaries, apparently because the service corporation application only requested "borrower" authorization. We have been unable to determine any intended or actual difference between the terms "savers" and "accountholders."

^{6/} The Board recently refused to authorize an expansion of the "borrowers and savers" customer base to include customers of joint venture projects involving subsidiaries of the applicant association. See item #5 under "Customer Base," above.

- 6 -

1. Related to extensions of credit by other financial institutions or subsidiaries thereof.
4. Not related to any extension of credit.
4. Customers of the applica- association's subsidiar.
5. Customers of the applica- association's joint ven- tures.
6. Customers of the applica- association's affiliate: if the association is ow- by a holding company.
7. Borrowers, accountholder and/or customers of any other association or ser- vice corporation thereo
8. Members of general publ.

We have reviewed the Board's prior decisions in the area, as well as the underlying applications and concluded that, at a minimum, in these previous approvals the Board intended to permit applicants to underwrite/reinsure insurance which is credit-related as that term is described in item 1 of "Insurance Type," above, and that provision of this service to borrowers and savers encompasses the meanings set out in items 1 and 2 of "Customer Base," above. Moreover, as the original intent of the "customer-only" condition was to preclude insurance activities from being offered to the general public, it would not be inconsistent with prior approvals to construe the "Customer Base" category to include items 3 and 4. Further, in our opinion, any combination of items 1 and 2, under "Insurance Type" and items 1 through 4 under "Customer Base," above, would satisfy the "reasonably related" standard for service corporation approvals by the Board.^{7/} Nor would any of the foregoing appear to be inconsistent with the Garn-St Germain conference report language discussed above.

We welcome any clarifying direction the Board may wish to make in connection with the scope of insurance underwriting/reinsurance which it is willing to approve.

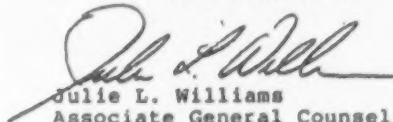
^{7/} Regarding item #2 under "Insurance Type", we note that the Board permits the non-insured subsidiaries of multiple savings and loan holding companies to underwrite or reinsure contracts of credit life or credit health and accident insurance in connection with extension of credit by the holding company or any of its subsidi- aries, or extensions of credit by any insured institution or service corporation thereof, or any other multiple savings and loan holding company or subsidiary thereof.

- 7 -

V. SUMMARY CONCLUSION

On the basis of the foregoing, therefore, we have no legal objection to conditioning approval of the underwriting of the various types of insurance sought by the application on the insurance being directly related to extensions of credit by [REDACTED] or a service corporation thereof, or by other sources, provided that insurance is offered only to borrowers and savers (including transactions accountholders) of [REDACTED] or its service corporation.

CORPORATE AND SECURITIES DIVISION STAFF CONTACT: James J. McCarthy
EXTENSION: 6740

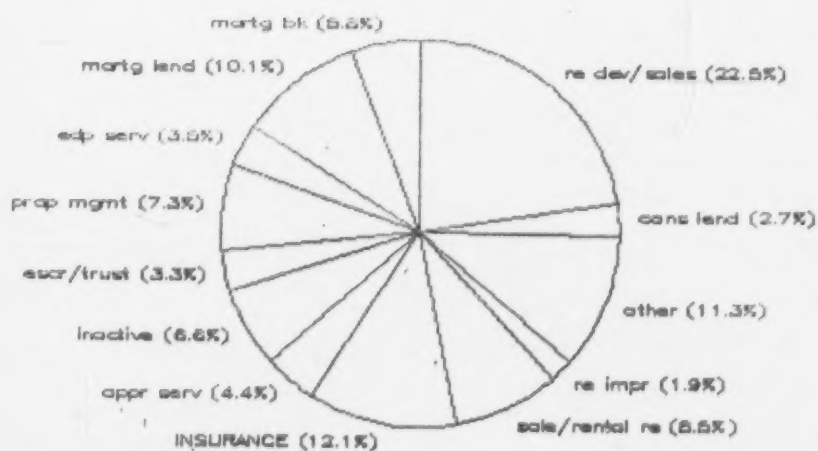

Julie L. Williams
Associate General Counsel
Director, Corporate and
Securities

SERVICE CORPORATION SURVEY
 ACTIVITIES ENGAGED IN BY SERVICE CORPORATIONS
 AS OF DECEMBER 31, 1984

Exhibit 2

ACTIVITY DESCRIPTION	TOTAL SERVICE CORPORATIONS PARTICIPATING IN ACTIVITY	% OF TOTAL ACTIVITIES
RE DEV. & SALES	1460	22%
PROP. MGMT.	472	7%
MORTGAGE BANKING	375	6%
MORTG. LENDING	653	10%
CONS. LENDING	178	3%
INSURANCE	785	12%
APPRAISAL SERV.	284	4%
EDP SERVICE	230	4%
OTHER	732	11%
INACTIVE	428	7%
SALE/RENTAL RE	555	9%
RE IMPR. LENDING	126	2%
ESCROW, TRUSTEE	215	3%
TOTAL	6493	100%

ACTIVITIES ENGAGED IN BY SERVICE CORPS.
 AS OF DECEMBER 31, 1984



Question 6:

In his testimony, Mr. Volcker suggested that joint marketing of products and services which are not permitted to a bank holding company be prohibited for thrifts and their affiliates. What is your view?

Answer:

For three reasons I do not believe that the joint marketing of products or services of thrifts and their affiliates should be prohibited. First, the Bank Board already has some very specific and tough regulations dealing with separate corporate identities and separate facilities of savings and loans and their service corporation affiliates. In general, only loan on deposit transactions may take place in the lobby of a federal association.

Second, while some few savings and loans might have more joint marketing opportunities than banks, it is a single and relatively small advantage. If all institutions had absolutely identical powers, then the institutional distinction between bank and thrift and between state charters and federal charters would disappear.

Third, such joint marketing should be prohibited only if abuses existed. In the long run no producer has any incentive to charge a below-market price. Furthermore, the jointly marketed products or services are all highly competitive, and it is totally beyond believability that any institution could seriously think it could attain a monopoly position in marketing these services at a significantly below-market price.

Question 7a: With regard to the "Heads I win, tails FSLIC loses" mentality which exists with some savings and loan executives:

- a. Wouldn't requiring a real capital investment by stockholders solve most of the problem for stock institutions?

Answer:

Requiring a real capital investment by stockholders would indeed solve most of the problem for stock institutions. Accumulating and holding capital in a thrift institution can reduce the risk of loss or potential insolvency to depositors, creditors, and others. Further, the role real net worth plays in safeguarding FSLIC is evident in that net worth acts as a deductible between the insurance fund and any thrift, thus reducing the risk exposure of the insurance fund. Finally, a combination of wise regulation, close supervision, and an ample deductible discourages the "heads I win, tails FSLIC losses" mentality and helps create a self-interest propensity that would benefit both the stockholder and the FSLIC fund.

Question 7b:

In the case of mutuals, wouldn't increasing the swiftness and the dollar amount of civil money penalties against officers and directors be advisable? How many civil money penalties has the FHLBB or FSLIC instituted over the last two years? What is the average dollar amount?

Answer:

The Bank Board and FSLIC presently have no statutory authority to assess civil money penalties for an institution's or individual's unsafe or unsound practices or violations of regulations (except Holding Company Regulations and willful violations of the Change in Control Regulations). Our fining authority in this area is limited to assessing penalties for violations of final cease-and-desist orders issued by the Bank Board. Fortunately, the number of violations of final Bank Board C&D orders are very few in number and consequently, we have even fewer civil money penalties. No penalties were assessed by the Bank Board for violations of C&D orders in the last two years.

As a matter of policy however, the Bank Board believes that the ability to halt an unsound practice or regulatory violation is far more important, and a better use of scarce agency resources, than fining the violator after the fact. Only if we possess the ability and authority to take swift and effective action to halt ongoing problems will our enforcement actions be effective at reducing losses for insured institutions and the FSLIC. It is for this reason that the Bank Board has proposed legislative initiatives to bolster the agency's temporary cease-and-desist authority so that it will be able to pursue injunctive-type orders to halt unsound practices and violations that threaten to harm an institution's financial condition.

There are other difficulties with civil money penalties including the fact that the assessment process takes several months and a considerable amount of attorneys' time to complete because due process demands that an individual receive a full hearing before a fine is assessed and collected. Moreover, where an institution has failed due to an official's misconduct or negligence, the FSLIC has an interest in recouping the losses that it has suffered by filing suit directly against the individual in question, or the insurance companies that bonded him. Any civil money penalties collected from the same individual are required to be paid to the Treasury. Therefore it is difficult for the FSLIC not to elect the first option if both are available to it.

Question 8: What is your view of Mr. Connell's President of Washington Mutual, suggestion to the Committee that officers and directors be required to adhere to fiduciary standards?

Answer:

In view of the number of thrift failures confronting the FHLBB during the past three years, we have addressed the issue of officer and director adherence to fiduciary standards with the following:

- Exhibit 1: FSLIC suits against directors and officers of failed institutions and others.
- Exhibit 2: Clarification of directors' responsibilities through Memorandum R-62 "Directors' Responsibilities" (attached).

FSLIC SUITS AGAINST DIRECTORS AND OFFICERS OF FAILED INSTITUTIONS AND
OTHERS, JANUARY 1982 TO DATE

FSLIC v. Pass, et al., C.A. No. 82-C-1283 (N.D. Ill.) (filed 3/2/82)

This was a suit against five former officers and directors of Unity SA, Chicago, Illinois, for negligence based on employment contracts entered into by these officers and directors just prior to the FSLIC's closing of Unity SA. These contracts provided for excessive payments to the officers upon their severance or upon the demise of the association. Case decided in favor of the FSLIC (578 F. Supp. 848 (N.D. Ill. 1983)).

FSLIC v. Alexander, et al., C.A. No. 82-0090, C.A. No. 82-1299 (D. Hawaii) (filed 6/8/82)

These suits name former officers and directors of the now-defunct First Savings and Loan Association of Honolulu claiming negligence, mismanagement and breach of fiduciary duty. The lawsuits charge that highly speculative lending, failure to perform cash flow analysis and excessive reliance on jumbo certificates of deposit caused the financial collapse of the institution. Trial is set for late 1985.

FSLIC v. James R. Yocum, C.A. No. K-82-220 (W.D. Mich.) (filed 7/6/82)

This case against former officers, director, and employees of First FS&LA of Niles, Michigan, is based on charged negligence and breach of fiduciary obligations for failure to supervise officer Yocum and failure to implement adequate internal controls. Unauthorized securities trading by Yocum forced this association into solvency. Related cases have been brought against First Federal's accountants and various brokers and others. All cases have been settled with the exception of three broker cases and the suit against Yocum personally.

FSLIC v. Coopers & Lybrand, C.A. No. K-82-01 (W.D. Mich.) (filed 1/5/82)

Suit against the accountants for First FS&LA of Niles, Michigan based on their failure to detect Yocum's misapplication of funds. Case has been settled.

FSLIC v. J.R. Dixon, III, C.A. No. N-83-116 (E.D. Va.) (filed 2/14/83)

This case against former officers and directors of First S&LA, Suffolk, Virginia, which failed in 1982, for alleged negligence and mismanagement by association officials, was based on real estate loans and projects on several condominium ventures. The case has been settled.

Page Two

FSLIC v. Boykin, C.A. No. 85-85 N (E.D. Va.) (filed 1/30/85)

This suit, which also arose out the failure of First S&LA of Suffolk, alleges misconduct against a real estate developer and an appraiser in connection with certain bad loans by the association. The case is in a discovery stage.

FSLIC v. Canche, C.A. No. 83-0057G(M) (S.D. Calif.) (filed 8/30/83)

This case alleges negligence, mismanagement and breach of fiduciary duty on the part of former officers and directors of Valley First Federal Savings and Loan Association, El Centro, California, now in FSLIC receivership, for approving a series of highly speculative loans that resulted in the financial collapse of the institution. It also alleges that two former officers and a money broker defrauded the association in arranging these loans for approval by its board of directors. The case is currently pending.

FSLIC v. James R. Elliott, C.A. No. C-83-1803 (N.D. Ill.) (filed 3/15/83) and FSLIC v. Powers, No. C-83-2937 (N.D. Ill.) (filed 4/28/83)

These suits against officers and directors of First Financial S&LA, Downers Grove, Illinois, are charged negligence, misappropriation of funds, breach of fiduciary duty, and improperly benefitting from association transactions. These charges are based on a series of complex transactions in which several parcels of association real estate were sold, resulting in a loss to the institution. The case is pending.

FSLIC v. Cini, C.A. Civ-83-2759 (S.D. N.Y.) (filed 4/11/83)

This case named the directors of the failed New York and Suburban FS&LA, New York, New York, for alleged negligence and willful misconduct based on their resistance to Bank Board efforts to resolve the problems of the association. The suit charged the directors with seeking personal financial benefits and immunity from suits for negligence in return for their approval of a merger agreement. The case is pending but a settlement has been reached in principal.

FSLIC v. Williams, C.A. No. Y-83-1422 (D. Md.) (filed 4/13/83)

This case accused the former directors and officers of County FS&LA of Rockville, Maryland, with breaches of fiduciary duty and violations of federal law in connection with numerous loan approvals. Settlements were reached with several defendants and a jury trial against the remaining defendants resulted in a verdict for the FSLIC.

FSLIC v. Ticktin, C.A. Nos. 83-C-2996, 2997, 2998 (N.D. Ill.) (filed 5/2/83) and FSLIC v. I-Tex Energy Corp., C.A. No. 83-C-3995 (N.D. Ill.) (filed 6/10/83)

Page Three

These cases are suits filed against former directors, officers, and business associates of the failed Manning S&LA, Chicago, Illinois, for gross negligence, misappropriation of association funds, and negligent lending and investments. These charges are based on numerous regulatory violations and unsafe and unsound practices by the officers and directors, resulting in substantial losses to the institution. These cases are all pending.

FSLIC v. Howard D. Huff, et al., C.A. No. 83-2169 (D. Kan.) (filed 5/19/83)

This is a case against officers and directors of North Kansas SA, Beloit, Kansas, for negligence in making numerous, poorly underwritten loans funded by assignments of pools of the association's low yielding mortgage loans. The association experienced losses when most of these loans became delinquent shortly after being granted. The case is pending.

FSLIC v. Laventhol & Horwath, C.A. No. CV-84-0129 (M.D. Pa.) (filed 1/27/84)

This is a case against the former president of First Federal Savings and Loan Association of Pittston, Pittston, Pennsylvania, charging fraud, conversion, breach of fiduciary duty, unjust enrichment, and violations of the Racketeer Influenced and Corrupt Organizations Act ("RICO"). The case also names a former director who allegedly benefitted from fraudulent and otherwise illegal share loans, for breach of fiduciary duty and violations of RICO. In addition the association's auditors are charged with breach of contract and fiduciary duty, fraudulent misrepresentation and violations of RICO. The case is pending.

FSLIC v. Blain, C.A. No. CA 3-84-1424-C (N.D. Tex.) (filed 8/24/84)

This suit against the former Chairman of the Board of Directors of Empire S&LA, Mesquite, Texas, charges breach of fiduciary duties, self-dealing, and usurpation of corporate opportunities in connection with certain real estate transactions. The case is pending.

FSLIC v. Collins, C.A. No. 84-C-10997 (N.D. Ill.) (filed 12/28/84)

Action against former directors and officers of Antioch S&LA, Chicago, Illinois, charging breach of fiduciary duties in connection with an employee stock option plan. This case is pending.

FSLIC v. Forde, C.A. No. 85-774 (C.D. Cal.) (filed 2/1/85)

Action against former directors and officers of San Marino S&LA, San Marino, California, to recover losses incurred as the result of breach of fiduciary duties and regulatory violations in connection with numerous bad loans. The case is pending.

Page Four

FSLIC v. McGladrey, Hendrickson & Co., C.A. No. CV-89-2975 (C.D. Cal.)
(filed 5/3/85)

Suit against former accountants for San Marino S&LA charging breach of contract and malpractice in connection with accounting work for the association. Case is pending.

FSLIC v. Loomis, C.A. No. C-85-636 (W.D. Wash.) (filed 4/12/85)

Suit against former directors, officers, and business associates of Queen City S&LA, Seattle, Washington for breach of fiduciary duties, fraud, misrepresentation, and regulatory violations in connection with numerous bad loans. The case is pending.

Exhibit 2

FEDERAL HOME LOAN BANK BOARD
OFFICE OF EXAMINATIONS AND SUPERVISION

M E M O R A N D U M

R 62

TO: OES Professional Staff

May 8, 1985

FROM: William J. Schilling

Directors'
Responsibilities

Regulations exist which delineate duties and limit activities of members of a thrift institution's board of directors. While it is the responsibility of each director to comply with all regulations, board members have a far broader responsibility to the institution to meet their fiduciary duties and to exercise reasonable care and due diligence in supervising the management of their institution's affairs.

I. General

Directors of a thrift institution have a duty of care and loyalty. The duty of care requires a director to act in good faith and with the care of an ordinary prudent person in a like position under similar circumstances. In the savings and loan business, directors must recognize that their institutions are primarily engaged in lending funds of their depositors or members to others. The directors have a primary responsibility to assure that the institution is operated prudently and in a safe and sound manner so that these borrowed funds will be adequately protected.

The duty of care includes the responsibility of the directors to select and retain competent management; to oversee the activities of the institution by attending directors' meetings; to require that adequate and reliable information is provided upon which they can make decisions; to carefully review the documentation which is provided; to make the necessary policy decisions upon which management is to operate the institution to monitor the activities that are delegated to the officers of the institution to insure that the board of directors' policies are being carried out; and to establish controls to assure themselves that the institution is being operated in a safe and sound manner and in compliance with law and regulations. "Directors who willingly allow others to make major decisions affecting the future of the corporation

wholly without supervision or oversight may not defend on their lack of knowledge, for that ignorance itself is a breach of fiduciary duty." Joy v. North, 692 F.2d 880, 896 (2d Cir. 1982).

Directors of a thrift institution also owe a duty of undivided and unqualified loyalty to the institution they serve. Thus, directors are not permitted to use their positions to profit personally at the expense of the institution. The duty of loyalty prohibits directors from usurping, for their own advantage, an opportunity that properly belongs to the institution or any affiliate thereof and from entering into unfair transactions or contracts with them. A director should not solicit or accept preferential treatment from the institution or its affiliates (other than that specifically allowable by law) with regard to loan terms or other investment offerings and should consistently seek to avoid any transaction which would give the appearance of preferential treatment or usurpation of corporate opportunity.

2. Oversight Responsibility

There must be an adequate system of checks and balances between management and the outside directors of a thrift institution to insure that the outside directors, who constitute a majority of the board, are promptly and fully informed of serious problems in the institution. There have been instances where the outside directors failed to learn of serious problems in their institution and, consequently, were unable to cause the institution to take adequate and timely steps to correct the situation before large losses occurred or the institution failed. While the outside directors cannot normally be expected to directly establish an adequate system of internal controls, they are responsible to ensure that one is put in place and that it is operating satisfactorily. This responsibility can be adequately met by properly structuring the board of directors into appropriate committees and by the use of outside experts and a compliance officer reporting directly to the board.

All members of the board of directors, however, should regularly attend board meetings; read reports of the institution and the committees of the board; study the reports of its auditors and the state and federal supervisory agencies; and give full attention to the reports of the audit committee, other committees of the board, the compliance officer and outside experts. It is to be noted that no check and balance system can effectively work unless those concerned with providing information to the board report directly to the board or a committee of the board. The information must not be diluted, distorted, or muted by management. Of course management should be given a full opportunity to respond before any action is taken.

3. Fiscal Operations

Each directors' meeting should include a review of financial reports. Figures used in the reports should be verified if they appear at all questionable and not simply accepted at face value. Federal and/or state examination report recommendations should be promptly followed. The audit committee, composed solely of outside directors, should provide for annual audits by an independent accounting firm and should assure the establishment of and adherence to a system of internal controls as well.

Directors are responsible for the establishment of a business plan which documents major financial policies, including asset/liability management, investments, and interest rate risk management. While such policies may actually be developed by management at the direction of the board, the directors must thoroughly review and give final approval to each contemplated action. Directors must also approve the institution's budget and ensure that it is realistic, allows for secure transactions and reflects adequate capital.

4. Lending Operations

Loans constitute a institution's major asset and as such warrant careful clear-cut policies in regard to their substance and the approval process. A board should make the final determination of what types of loans should be made. Minimum written underwriting standards and guidelines must be established and adhered to. Policy should require high-risk or unusual loans to be presented to the board for final approval. The institution's capabilities and the risks involved should be carefully assessed, to insure that the institution has adequate resources to engage in the proposed activity and the return merits the risk undertaken. Efforts to minimize such risks should be fully explored and careful limits should be placed on the amount invested in such loans consistent with the responsibility of the directors to the institution's shareholders, members, depositors, and the public. Loan policies should be made not only with the institution's capabilities and community's needs in mind, but with the responsibility of the institution to operate in a safe and sound manner.

5. Public Relations/Business & Personal Affiliations

Directors should be ever-mindful of the institution's obligation to serve the community. Directors are institution representatives and their behavior can enhance or detract from the association's image and ultimately its fiscal well-being. A director's business and personal affiliations should not be incompatible with those of the institution. Conflicts of interest of any sort should be particularly avoided.

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Because a director's personal characteristics may reflect on the institution's trustworthiness, a director should be a responsible and trusted member of the community.

6. Personnel

Probably the most important part of a director's responsibilities is the selection of a managing officer for the institution. Directors should be prepared to let management manage and so should be careful with their choice of a chief executive who runs the institution's day-to-day operations. Directors should define in writing a managing officer's duties and responsibilities. They should establish reasonable salaries and pension plans and approve promotions and bonuses as appropriate.

The deregulated business environment places additional responsibilities on board members. It is incumbent upon the board of directors to thoroughly review any proposed new activity to assure themselves that the venture is pursued in a safe and sound manner and the risks assumed are reasonable ones for the institution to take under the circumstances.

Directors are responsible for operating results. As such, adherence to the following procedures should assist the board of directors in obtaining adequate and accurate information upon which to make informed decisions.

1. Documentation

Thorough documentation evidencing the details of all business transactions should be an integral part of an institution's books and records. The records should reflect regulatory compliance and adherence to safe and sound procedures. The directors should have full access to such records and should utilize them in decisionmaking relative to loan approvals, investment transactions, etc. The board of directors' meeting minutes should indicate that the directors are cognizant of and have studied documentation upon which their decisionmaking is based. Each director should have the opportunity to review, and modify if necessary, the minutes before they are approved.

2. Audit Committee

An audit committee, composed totally of outside directors, should be appointed to select the outside auditing firm and discuss the scope and results of the audit. It is recommended that the audit committee also select and employ a compliance officer who should be under the direction and control of the audit committee. Membership on the audit committee should not be considered a mere titular honor but a demanding responsibility requiring an active role.

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3. Compliance Officer

The employment of a compliance officer is also recommended as part of a sound checks and balances system. It is the duty of this officer to monitor all institution business transactions to ensure their compliance with regulatory provisions and their safety and soundness. The officer should be selected by and report to the audit committee.

4. Compliance Audit

Compliance audits may be made annually by the internal compliance officer, or in the absence of such an employee, by the board of directors' audit committee or its outside auditor. An audit of this nature will give the institution an opportunity to resolve or remedy any internal problems which might later be the subject of an adverse Bank Board or state examination report.

5. Adequate Insurance Coverage

Adequate fidelity bond and directors' and officers' insurance coverage should be maintained to protect the institution and its officers and directors. The directors should periodically review the adequacy of their coverage and review carefully the riders thereto that might impair its utility. The terms of these policies are negotiable.

The actions (or inactions) of a institution's board of directors will be scrutinized by examiners at each examination. Examiners should report as deficiencies those instances where boards are not adequately involved in or informed of institution affairs; where the system of checks and balances between management and the board is deficient; where minutes do not reflect a clear record of their deliberations or where actions do not reflect safety and soundness. Supervisory Agents should require whatever corrective action is deemed appropriate.


William J. Schilling
Director

Distribution to State supervisory authorities to be made by District Directors-Examinations.

Question 9:

What is your view of the unitary savings and loan holding company? It is my understanding that every study conducted by the FHLBB has consistently shown savings and loans in unitary holding companies are the most stable and profitable. Is this true? If so, shouldn't we seek to expand the number of unitary savings and loan holding companies rather than limiting them?

Answer:

It is true that some of the unitary diversified holding companies operate profitable and well-run institutions. The Bank Board welcomes and encourages diversified holding companies that wish to acquire an institution for investment purposes. The Board, however, has a great concern regarding the acquisition of a FSLIC-insured institution by an organization or individual that wishes to funnel insured deposits into business lines other than the provision of economical home finance.

Question 10:

In his testimony, Doug Timmerman of Anchor Savings and Loan believed that affiliating with a realtor was a natural progression for his company. Do you believe federal savings and loans should be given the same authority? Why?

Answer:

Those who oppose the association of real estate brokerage firms with thrifts cite potential conflicts of interest or significantly mis-priced loans used to facilitate a real estate sale. I believe these fears are greatly overestimated. A mortgage lending institution should grant equivalent loans at the same rate whether or not an affiliate stands to earn a real estate commission. To do otherwise would reduce the long-run profitability of the firm because, presumably, the sale will eventually be made whether or not the thrift affiliated with the real estate broker provides the financing. If appropriate safeguards can be established to prevent conflict-of-interest situations, it seems that thrifts and real estate brokers should have a natural affiliation. Both deal with households in the purchase, sale, and financing of homes.

Questions for Chairman Gray from Senator D'Amato

Question 1:

Recently, Chairman Volcker made a speech in which he called for the nation to move towards full interstate banking. As I understand it, he suggested that regional banks be the first step followed by a definite trigger into full interstate banking.

What is your appraisal of Volcker's speech? Do you agree or disagree and why?

Answer:

Whether we like it or not, regional interstate banking is or soon will be a reality given the recent Supreme Court decision permitting regional banking compacts. Any form of interstate banking, however, will drastically undermine the health of FSLIC, and undo the expressed wishes of Congress to alleviate thrift industry problems through the enactment of Garn-St Germain. The expressed will of Congress was to reward the acquirers of weakened thrifts with interstate access in return for their willingness to assist FSLIC to resolve thrift problems cases and thereby help safeguard the reserves of the insurance fund. I believe this step will undo these efforts and will seriously jeopardize the well being of the FSLIC.

Question 2:

Chairman Volcker also expressed concern over the potential size of bank acquisitions. I believe that Volcker suggested that very large banks could not acquire other large banks across state lines.

Do you agree with this statement by Volcker? What parameters would you set on the size banks that may be acquired across state lines? Are these restrictions needed because federal insurance may not be able to handle a failure of a massive bank much larger than say Citibank or Bank of America?

Answer:

At the present time 17 institutions have assets in excess of that of the FSLIC fund. The situation is roughly comparable with respect to banks and the FDIC fund. Clearly, the deposit insurance agencies cannot liquidate all the assets of the very largest institutions.

The more appropriate reason to limit the size of banking acquisitions is to prevent the concentration of resources and to maintain the decentralized nature of the American banking system, even while admitting that the ultimate number of institutions will be in the hundreds not thousands.

BANKS SEEKING TO CONVERT TO THRIFT CHARTERS

The CHAIRMAN. Last week Chairman Isaac told the committee that a growing number of banks were seeking to convert to thrift charters in order to escape bank regulatory agencies' tougher capital accounting and disclosure rules. Chairman Isaac described this as competition in laxity. He was concerned about this and he felt that the tougher rules of the FDIC were more applicable and that they should not be able to do this.

How would you respond to Mr. Isaac's charge of competition in laxity and conversion to thrifts for easier regulation?

Mr. GRAY. Well, with respect to the notion of laxity, I would probably prefer not to dignify that with a comment.

The Federal Home Loan Bank Board, as you know, has been striving, I think tremendously in these past several years, to deal with a new regulatory environment to regulate institutions and to operate an insurance fund. This transition from a highly regulated environment to a deregulated environment has made it difficult not only for our system but for our institutions.

The commercial banks in our country did not have the same kind of problems which thrifts encountered when they entered this new environment and it has obviously been difficult for all parties.

But to suggest that there is some kind of deliberate laxity on the part of the Federal Home Loan Bank Board and the men and women of the Federal Home Loan Bank System is just plain wrong.

It is true that we have not been provided as many examiners as we would have liked in the past, but I think the Federal Home Loan Bank Board has taken a great step forward in moving our examination force to the Federal Home Loan Banks which will enable us to attract and retain far more examiners. That will certainly help us in our efforts in the supervisory and examination area.

When thrifts entered this very difficult period of 1981 and 1982 they had mostly fixed long-term assets on their books and had really been denied the opportunity during the decade of the 1970's to have genuine adjustable rate mortgages. As a result, they are still living with the residual effects.

So to say that the capital standards of the thrift industry are somehow arbitrarily being kept low by the Federal Home Loan Bank Board would be to distort the entire situation.

If there are banks that want to come into the Federal Home Loan Bank System, be regulated by the Federal Home Loan Bank Board, if they meet the appropriate tests to do so, if they apply for insurance of accounts and so on and so forth, I think they ought to be able to do that. But I do not agree that it is for the purpose of getting into a system that is somehow deliberately lax, a system that is unwilling to face up to the problems.

So I would disagree with the general thrust of what Mr. Isaac was saying.

The CHAIRMAN. Mr. Chairman, I don't think that he was in any way indicating there was laxity on the part of the Federal Home Loan Bank Board or the examiners, but simply that the standards are tougher as with the capital accounting and disclosure rules. I

don't think there was any attempt on his part to say you are over there being lax. I did not interpret that in any way—I doubt if any member of the committee did.

Is it a fact that there are less stringent capital accounting and disclosure rules to be a thrift than a bank and, if so, is that the reason they are making the shift? Now I have seen some indication of that to back up what he says that they have decided to move over for that very reason.

Mr. GRAY. Well, he has to approve the move of commercial banks under his supervision to the Federal Home Loan Bank System. He has exacted some rather stringent requirements when that occurrence takes place, but essentially those institutions that want to enter our system are expected to enter at roughly the same capital standards, just as the Ohio thrifts entered at 5 percent and we required a 5-percent net worth maintenance for them once they received FSLIC insurance, and we are in fact working on a continuing basis to deal with the capital adequacy problems of our industry. I think that we are moving in the right direction in terms of accounting. That is going to take some time because this transition has not been easy now, nor will it be easy in the future. As the Bush task force suggested, that a commercial bank that meets an appropriate thrift test ought to be able to come into our system and I think that makes sense if they essentially want to concentrate their asset portfolio in housing.

RUN ON THRIFTS

The CHAIRMAN. Well, this is obviously going to be discussed at considerable length today. You mentioned the Ohio situation. Now we've got the Maryland situation. And whether it is fair or not, whether it is right or not, whether some of the people are panicking unnecessarily, which they obviously are, it appears to me that the private and State insurance funds are on their way out. I just don't think that the confidence is going to be there. I don't happen to think that it is necessarily correct, but it's the perception that is there. So it looks like you are going to be called upon—when I say you, I mean the Federal Home Loan Bank Board—to absorb more and more so that there is the confidence of the FSLIC and the full faith and credit to stop these runs, particularly when they are institutions that are not in trouble, but people think they are and start to withdraw their money.

Mr. GRAY. If I may give you an update—

The CHAIRMAN. Let me simply ask the question I was going to ask. Do you think we should pursue, for the Federal Home Loan Bank Board, tougher capital accounting and disclosure? As you're going to see more and more institutions seeking to join the system, should we be considering tougher standards, like the bank standards for thrifts?

Mr. GRAY. Well, for an institution to enter our system from Ohio or from Maryland, they have to meet the 5-percent snapshot net worth standard and they are also required to maintain 5-percent snapshot net worth.

As I say, we are continuing to work toward the same goal as the commercial banking regulators; that is, to bring thrifts into—over

time—greater conformance with accounting standards and capital standards, but that is going to take a while.

The CHAIRMAN. In his testimony this morning—I looked at his testimony in advance—Mr. Bergman, of the National Association of State Savings and Loan Supervisors, criticizes your proposals. He said, one, to require the FSLIC to reject an application for insurance of accounts if it was determined that there was no necessity for the applicant thrift institution in the community to be served; and, two, prohibit State-chartered FSLIC-insured thrift institutions from engaging in any activity not permitted for federally chartered thrifts or their holding companies.

Mr. Bergman describes your proposal as the first step to a concentration of economic power in the Bank Board.

How would you respond to those two criticisms of your proposal?

Mr. GRAY. I disagree. First, let me say that I and my colleagues on the Federal Home Loan Bank Board are strong advocates of the thrift industry and their role in housing finance. State treasuries and their legislatures which charter about one-half of our federally insured thrift institutions are held totally harmless from any risk of loss. The risk of loss is only borne by the FSLIC and there has developed over a period of time a great diversity between thrift powers in some States—not all States—and federally chartered institutions.

In my view, we have seen far too many failures and a movement toward insolvency on the part of far too many thrift institutions, particularly in those States where the powers granted by State legislatures are the most liberal. That is a fact.

And if that is the case, we have to find some way as an insurance carrier to underwrite the risk of loss. That's why we have proposed our risk-based premium.

In the case of some States, the kinds of activities which they are allowed to engage in go so infinitely beyond what was provided in Garn-St Germain, including the ability to engage in direct equity investments for all matter of things—leave it up to your imagination. Whatever you can think of they can engage in—own and operate restaurant chains, oil drilling operations, Arabian breeding horses—I could go through a long list.

OPERATION OF FSLIC SYSTEM CRAFTED IN GARN-ST GERMAIN ACT

I have to ask whether that is a proper incident to the operation of a thrift. It seems to me that the whole foundation of the Federal Home Loan Bank System and the reaffirmation of that system was carefully crafted in the Garn-St Germain Act and gave us an idea of what the Congress must have felt was properly incident to the operations of a thrift.

So essentially what we are trying to do is to keep in mind the basic public policy underpinnings of our thrift system on the one hand and, on the other hand, to better underwrite the risk of loss.

If we cannot underwrite the risk of loss through a special risk premium that we have proposed, then we have to do that by regulation. Every time we do that there's a suggestion that we are somehow interfering with States rights. There is only one Federal insuring agency that ultimately, if it were ever to not make it, the

Federal taxpayers would be at risk. So we have to find a way to better underwrite the risk of loss. We have a mandate at the Federal Home Loan Bank Board to protect the safety and soundness of that insurance fund which is a key structural leg of our Federal deposit insurance system.

So I would reject the notion that any proposal that we have made would constitute an undue infringement on States rights and our dual system which I very, very strongly support, but we cannot ignore the fact that there is for FSLIC-insured institutions but one insuring entity.

The CHAIRMAN. Mr. Gray, my time is up. If I can summarize your response then, you are not passing judgment or necessarily saying that State legislatures do not have the right to grant these powers for State-chartered institutions. However, if you are required to insure them, then you feel strongly that they should either have to pay a higher premium because of those more risky powers they have granted or that there must be regulations to protect the fund. If they do not desire to have that Federal insurance, then if they want to grant those powers, that is their business.

Mr. GRAY. I would go a little further than that, Mr. Chairman. There are some public policy imperatives that we cannot ignore.

What was the initial purpose of Federal Home Loan Bank credit? Such credit provides federally insured institutions with the ability to operate with both the backing of the full faith and credit of the United States and with the ability to attract vast amounts of funds using the FSLIC license. This provides these institutions very special status which, as the Garn-St Germain Act preamble suggested, was for the basic purpose of operating a thrift, with a primary focus on housing or a home ownership orientation. I and my colleagues believe that when that kind of credit and that special protected status are used to purchase and operate restaurants and other activities that have absolutely nothing whatsoever to do with real estate or with housing, then there is some conflict between the fundamental public policy underpinnings of our system. I question this inconsistency from a public policy point of view and I raise that issue before you.

The CHAIRMAN. Well, I don't disagree. We have a difficult problem because no one is more of a defender of States rights than I. But on the other hand, it's an area we have to pursue and I don't have the answers. If it endangers the Federal insurance fund and it is also unfair to Federal-chartered institutions who are not allowed to do those sorts of things and, in my opinion, should not be allowed to do those sorts of things, you've got an unfairness issue there as well.

My time is up. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Gray, I want to follow up on what you and Chairman Garn were discussing, particularly with respect to the difficulties in Ohio and Maryland.

According to press reports, most of the difficulties in Maryland stem from direct investment in real estate development projects. Recently the Bank Board moved to limit the direct investments of State-chartered savings and loan associations. Those regulations were strongly attacked by two eminent economists, as you know,

Alan Greenspan and George Benson, who argue that these are the very kind of profitable investments that savings and loan should be making to improve their earnings and capital base.

What have we learned about this controversy in the light of the recent experience in Maryland?

Mr. GRAY. Well, I must say that we have had no involvement whatsoever in Maryland. We have had no examination resources, no supervision there. We really have no way of knowing what has gone on in Maryland. We know, of course, the investments engaged in by our own FSLIC supervised institutions. So I can't really speak to what has happened in Maryland. We presumably will find out in due course.

ESTABLISH A SUPERVISORY THRESHOLD

Our regulation was not intended to limit direct investments by State-chartered institutions. It was, rather, to establish a supervisory threshold at which when either twice net worth was reached or when 10 percent of assets was reached in certain specified activities, the principal supervisory agent in any one of our Federal Home Loan Banks would have an opportunity to examine the institution's business plan and assess the possible effects on the FSLIC. Insured institutions exceeding those thresholds—and I want to call them thresholds, not limits—would subject the institution to supervisory scrutiny which will allow for protection of the FSLIC and will enable institutions that are well-capitalized, well-run, and have a good track record to exceed those thresholds.

Senator PROXMIRE. Let me ask you: What position did the Reagan administration take on the Bank Board's proposed regulation to limit direct investments?

Mr. GRAY. They took no formal position on that particular regulation.

Senator PROXMIRE. How about as an informal position? Did you have any conversations with them or contacts or anything?

Mr. GRAY. I did have conversations with folks at Treasury, not at the White House, in the general course of policy development and they certainly understood my concerns. Therefore, I heard no objections raised by the administration or any political party.

Senator PROXMIRE. Well, will you for the record provide the committee with a detailed list of all contacts you have had with officials of the Reagan administration on the direct investment regulation, including dates and the names of officials involved, and the substance of what they said?

Mr. GRAY. Yes.

[The following information was subsequently submitted for the record:]

I cannot respond precisely to your request, Senator Proxmire because the nature of my contact was telephonic, but I can provide you with my best recollections of contacts with administration officials on the proposed direct investment regulation.

My sole contact on the issue involved one, or at most two, telephone calls with Treasury's then-Assistant Secretary for Domestic Finance Thomas J. Healey, in the weeks preceding the Board's final action on the direct investment regulation. During that contact I sought Treasury support for the Board's proposed regulation. At that time, Assistant Secretary Healey indicated that Treasury would remain neutral on the proposed direct investment regulation. To my knowledge, Treasury has never taken a position on the subject.

Senator PROXMIRE. Federal Reserve Board Chairman Volcker and Vice Chairman Martin have testified that federally insured depository institutions should not be allowed to invest in junk bonds.

Do you agree?

Mr. GRAY. First, there are only a handful of thrift institutions that are engaged in any way so far as we can tell in junk bonds—so-called junk bonds. Maybe a dozen that we have been able to determine.

It is our belief that it goes very, very far afield from a commitment to housing finance for a thrift to purchase a junk bond or take a commitment in an activity which is directly related to a corporate takeover and for that reason I think it is contrary to those same philosophical underpinnings that I talked about relative to the Federal Home Loan Bank System.

With respect to the authorization of such investments by State legislatures as a permissible activity for their FSLIC-insured institutions we believe that the best way to address that is through an additional special risk premium.

We are also looking right now and we will be moving, I think, expeditiously toward regulatory proposals to better underwrite junk bonds, if I can use that term loosely. The use of thrifts' involvement in purchasing junk bonds or in engaging in commitments involving junk bonds for greenmail or corporate takeovers goes well beyond anything ever contemplated when Congress authorized the provision of the Federal Home Loan Bank credit and the ability to attract funds or operate on the full faith and credit of the United States.

Senator PROXMIRE. Now you say that there's not very much investment by the S&L's. Can you provide the committee with statistics on the extent of the junk bond holdings by insured savings and loan associations?

Mr. GRAY. Certainly.

[The following information was subsequently supplied for the record:]

Federal Home Loan Bank Board



1700 G Street, N.W.
Washington, D.C. 20002
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

OFFICE OF POLICY AND ECONOMIC RESEARCH

May 7, 1985

MEMORANDUM FOR: FEDERAL HOME LOAN BANK BOARD

FROM : Eric I. Hemel
DirectorRichard C. Pickering
Deputy Director

SUBJECT : Thrift Industry Holding of "Junk" Bonds

The following summarizes the result of a special survey of FSLIC-insured institutions conducted by the Federal Home Loan Banks at our request in order to provide an estimate of industry holdings of "junk" bonds on March 31, 1985. A sample of 352 institutions were surveyed, comprised of all institutions reporting holdings of non-Federal government/agency securities at yearend 1984 in excess of \$70 million and a random sample of other institutions, with the sample subdivided into 3 strata. While the number of institutions in the sample was small, they accounted for nearly 70 percent of the industry's holdings of non-Federal government/agency securities. "Junk" bonds for purposes of the survey were defined as debt securities that are either not rated by a nationally recognized investment rating service or were rated by one or more such services as below investment grade. Except as noted below, the survey covered only "junk" bonds held by insured institutions, excluding those held by service corporations/subsidiaries, and only those classified as securities, even though the distinction between a loan and a security is not always clear-cut and the former, therefore, can be used to conceal "junk" bond holdings.

- (1) FSLIC-insured institutions are estimated to have held \$4.0 billion of "junk" bonds on March 31, 1985. This represented 0.4 percent of industry assets.
- (2) Most "junk" bonds were held by a few large institutions. Ninety-five percent of the estimated total volume was held by the 200 institutions with the largest holdings of non-Federal government/agency securities (which were all included in the survey) and 79 percent by the 10 institutions with the largest "junk" bond holdings.
- (3) About 23 percent of the 200 largest institutions reported holdings of "junk" bonds, but only an estimated 3 percent of the smaller institutions.

- (4) Most "junk" bonds were held by associations in three FHLB Districts. Of the \$3.8 billion held by the 200 largest institutions, 52 percent (\$2.0 billion) was held by institutions with home offices in the San Francisco District, 24 percent (\$0.9 billion) was held by institutions in the Dallas District and 18 percent (\$0.7 billion) was held by institutions in the Atlanta District. (The sampling procedure used does not permit accurate allocation among Districts of the \$0.2 billion estimated to be held by smaller institutions).
- (5) While the survey covered only "junk" bonds held directly by insured institutions, San Francisco also inquired into holdings of "junk" bonds by subsidiaries. About \$1.2 billion of such holdings were reported, with most of the dollar volume at one service corporation (this amount, of course, should be added to the aforementioned \$4.0 billion estimate for direct holdings of insured institutions). In addition, the Pittsburgh District reported approximately \$4 million of "junk" bonds holdings classified as commercial loans, rather than securities, by three institutions.

cc: S. Fairbanks
J. Gould
D. Boyle
J. Butler
F. Haas

B. S. Moore
N. Raiden
W. Schilling
P. Stearns
A. Withers

FHLB Presidents

Senator PROXMIRE. You referred earlier in answer to Chairman Garn's question about the capital adequacy of the S&L's. I understand the savings and loan associations have a total regulatory net worth of about \$39 billion. How much would this be if calculated according to generally accepted accounting principles? Considerably less, right?

REGULATORY NET WORTH IS 3.38 PERCENT

Mr. GRAY. We have virtually no tangible net worth in our industry and the ratio of regulatory net worth is 3.88 percent at last report.

Senator PROXMIRE. But that is not according to generally accepted accounting principles, is it?

Mr. GRAY. Well, we have accounting procedures that do not follow generally accepted principles. I suppose that someone could say that the use of goodwill, for example, would be a questionable accounting device, but the use of goodwill, of course, is a part of generally accepted accounting principles. We do allow deferred loan losses that were instituted during 1981 and 1982 when the industry had such severe earnings problems.

Senator PROXMIRE. Now Chairmen Volcker and Isaac said we should not extend the Net Worth Certificate Program unless the thrifts were given a mandate to achieve capital adequacy according to generally accepted accounting standards by a date certain.

Do you agree and, if so, how long should it take?

Mr. GRAY. Well, I would hesitate to suggest a timeframe. By the way, my Director of the Office of Policy and Economic Research informs me that our GAAP net worth would be about 3 percent as a ratio.

Senator PROXMIRE. As I understand it, the Bush Commission report recommended 7 years, which you signed.

Mr. GRAY. That was what was unanimously agreed to in the report, yes, and that as I recall was basically an objective, a goal to reach. Whether or not the framers of any proposed legislation specified that something be reached in 7 years is something I'm not aware of. But that was generally the goal that they were seeking.

Senator PROXMIRE. My time is about up, Mr. Chairman. I have a longer question that will take some time to answer, so let me submit these questions for the record. Unfortunately, I have to leave for another committee. Thank you very much.

[Response to written questions of Senator Proxmire follow:]

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN



1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

August 2, 1985

Honorable William Proxmire
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

Enclosed as requested by your staff are the responses to your follow-up questions to my testimony on change in the financial services industry.

If you have any further questions, please don't hesitate to contact me.

Sincerely,

Edwin J. Gray

QUESTION 1:

The National Council of Savings institutions is strongly opposed to any thrift test for savings institutions. They argue that a thrift test will force them into making too many unprofitable mortgage loans and that it is inconsistent with the trend towards financial de-regulation set by the Congress over the last several years.

What is your response to these arguments against the thrift test?

ANSWER 1:

I believe it is fundamentally misguided to frame a debate about the propriety of a "thriftness" portfolio test upon simplistic labels such as "reregulation" or "deregulation." Indeed, that approach ignores the fact that the Congress itself, in enacting the Garn-St Germain Act of 1982, expressly set out a "Thriftness" test — based on the 60% portfolio composition test of I.R.C. 7701(a)(19)(C) linked to the bad debt deduction — to determine the authority of a thrift to be acquired by a diversified unitary savings and loan holding company and to determine the authority of federal savings and loans to engage in interstate branching in non-supervisory circumstances.

While the Board has strong reservations about the particulars of the "thriftness" test incorporated in S.2851, as passed by the Senate last year, we strongly support the principle of such a test. I believe that an appropriately structured asset composition test, such as the one contained in S.759, the Board's legislative proposal, provides the most equitable and realistic means of preserving the specialized function of thrifts by distinguishing such institutions and extending to them unique regulatory benefits based on a dedication to housing finance and other housing-related investments.

We believe that such a test is a vital part of any changes in bank or thrift regulatory authorities because it recognizes the reality that thrifts and banks continue to function quite differently in the marketplace. Such a test assures that institutions with a substantial commitment to housing finance will continue to function within a framework specifically fashioned to aid their mission. As I have frequently stated, if thrifts ever did become the equivalent of commercial banks, I do not believe there would be any sound basis for maintaining the Federal Home Loan Bank Board, the Federal Home Loan Bank System, or the Federal Savings and Loan Insurance Corporation in a separate regulatory framework.

In my view, every institution with a thrift charter, whether state or federal, should be able to pursue diversification options. However, where such diversification involves abandoning home finance as a primary mission, an institution should not be allowed to compromise the purposes of the separate thrift regulatory structure by freely availing itself of

its benefits. An appropriate asset test would resolve this problem by denying future bank-like thrifts the benefits which ought to only accompany a substantial housing finance focus.

In my view, any asset composition test which reforms the current regulatory structure for insured depository institutions must be guided by three basic principles.

First, any such legislation must acknowledge the very basic differences, in statutory authorities and operating functions, between thrifts and banks. I reject any contentions that the intent or effect of the Garn-St Germain Act was to somehow transform thrifts into banks. Last year, thrifts closed a record \$165.6 billion in mortgage loans, 20% more than in 1983. At the same time they increased their share of permanent loans originated on 1-4 family property to 48% from 40% in 1983. While FSLIC-insured institutions have continued to increase their holding of non-mortgage loans authorized by recent legislation, such loans still accounted for only 3.2% of assets as of March of this year.

Second, any reform proposal must preserve and enhance, not reduce, the attractiveness of the thrift charter, to encourage the flow of new capital into the industry and to facilitate profitable use of the supplementary Garn-St Germain powers. This is especially important given the weakened condition of the thrift industry and its continuing sensitivity to interest rate changes.

Third, any such proposal should reaffirm the long-standing Congressional commitment to preserve an independent regulatory and deposit insurance framework for true housing-oriented thrift lenders, with regulatory power over such lenders and their holding companies vested exclusively in the Bank Board.

The Bank Board does, however, have grave concerns that without certain revisions, the S.2851 housing test could thwart the primary goal of the Garn-St Germain Act to revitalize and strengthen home lenders, by seriously compromising the ability of thrifts with a strong housing commitment to raise capital through conversions, to restructure and strengthen their portfolios, to reduce interest rate risk through appropriate diversification, and to survive and prosper in a variety of economic environments.

Under S.2851, the 60% "thriftiness" portfolio test would be linked to unitary diversification as well as eligibility of a thrift to receive advances from the Federal Home Loan Bank system.

Section 107 of S.2851 would provide that liquidity investments enumerated in the Federal Home Loan Bank Act, as well as a certain volume of mortgage banking originations, could be included in the 60% thrift portfolio test, but could not exceed 10% of the institution's assets.

The Board is strongly opposed to any mandatory legislative ceiling on liquidity as a component of the qualifying thrift portfolio test. Maintaining a portion of investments in liquidity items is neither a luxury nor a diversion from the home finance role. To the contrary, given the unstable economic conditions confronting thrifts since 1981, and the extremely cyclical nature of housing demand, a thrift must have maximum flexibility in its daily operations to keep a portion of assets in cash and items that are easily liquidated. Moreover, Board regulations currently require Federal Home Loan Bank members to maintain liquid assets in an amount equal to at least 5.0% of their deposits and short-term borrowing. To have any significant operating flexibility and to avoid violating this regulatory requirement, individual institutions must, on the average, carry liquidity well in excess of this amount. In recent years, the aggregate industry liquidity ratio has been over 10 percent.

Maintenance of liquidity is thus a critical management tool which undergirds a thrift's continued ability to deliver housing credit, especially with regard to its continued eligibility for the benefits available through Federal Home Loan Bank System membership.

The Board is similarly opposed to the proposed aggregation of credit for mortgage originations with liquidity under an arbitrary 10% ceiling. This approach is a double-edged threat to efficient management. In a period of low housing demand and rising rates, this approach could force managers to forego profitable loan sales — and the potential to offset losses arising from maturity mismatches which continue to threaten industry viability — if the cash generated could not be profitably deployed into non-liquidity assets allowing maintenance of qualifying status.

Eliminating these restraints is thus vital to the future viability of thrifts, and in our view would pose no threat to the industry's central housing mission. The Board would have ample authority under S.2851 to impose regulatory restraints on liquidity investment and secondary market activity to thwart potential misuse.

QUESTION 1 - FOLLOW-UP:

Will you provide this Committee with statistics on the number of thrift institutions that will meet the thrift test under last year's bill, S.2851, and how many will meet the test under the revised language the Bank Board is recommending.

We can provide only rough estimates of the number of FSLIC-insured institutions that would fail to meet the thriftiness test contained in S. 2851 and the alternative test recommended by the Bank Board because of the data items currently reported to the Board by insured institutions in some instances are defined in a manner inconsistent with the thriftiness test definitions. Approximations based on data for December 1984, however, indicated that about 450 institutions (14 percent of FSLIC-insured firms) would have failed the S. 2851 test, while only about 115 firms (4 percent) would have failed the Board's proposed test.

QUESTION 2:

As you know, the savings and loan holding company act limits the activities of savings and loan holding companies in the same manner that the bank holding company act limits the activities of bank holding companies.

However, there is a loophole in the savings and loan holding company act. The loophole allows a savings and loan holding company to engage in any activity it wants provided it does not own more than one savings and loan association. Bank holding companies used to have a similar loophole, but Congress closed it in 1980.

Is there any useful purpose served by the loophole in the savings and loan holding company act, and if not, why shouldn't it be closed?

ANSWER 2:

Your question appears to be founded on the faulty premise that thrifts and banks are essentially the same, and that their holding company structures should serve identical purposes. ^{1/} This is simply not so.

At the outset, it is important to distinguish the history and purpose of the one-bank holding company "loophole" and existing authority for unitary holding companies with broad diversification powers.

Until the amendments of 1970 to the Bank Holding Company Act ("BHCA"), the parent of a single bank was totally outside the scope of the Bank Holding Company Act, and its primary purposes of preventing undue concentration of control of credit and segregating banking and commercial enterprises. The Congress believed in 1956 that no need had been shown to subject such companies to regulation to carry out the basic goals of the BHCA. Between 1966 and 1970, a significant upward trend in assets held by such holding companies — and in particular affiliations involving numerous banks with assets exceeding \$1 billion, including the nation's six largest banks — led Congress to reassess the potential for abuse in such affiliation. Consequently, the 1970 amendments closed this "loophole." See, S. REP. 91-1084, 91st Congress, 2d Sess. (1970), reprinted in 1970 U.S. CODE CONG. & AD. NEWS 5520-5522.

¹ It is also crucial to note the fallacy of drawing an analogy between formerly unregulated one-bank holding companies and unitary savings and loan holding companies. Both unitary and multiple savings and loan holding companies have restrictions on their operations which have no parallel in bank holding company law and which circumscribe the flexibility of savings and loan holding companies to a much greater degree than bank holding companies. These restrictions, which relate to affiliate transactions and debt issuance, are set forth in detail in Appendix A to these Questions and Answers.

The history and purpose of the savings and loan unitary diversification option are fundamentally different from the former one-bank holding company exemption. More than a decade ago, the Congress established a separate holding company structure which was unique to thrifts. This structure enables holding companies to conduct a diverse array of activities that lend strength to their subsidiaries and permit different types of companies to acquire thrifts. The greater diversity enjoyed by thrift unitary holding companies, when compared with bank holding companies, reflects the Congress' longstanding recognition of the need to supplement the limited asset authority of thrifts.

Before enacting the Garn-St Germain Act, Congress completed a review of the entire savings and loan holding company structure. By deciding to retain that structure in its present form, Congress clearly reaffirmed its belief that the added flexibility provided by that format was, indeed, an appropriate supplement to the limited asset powers of thrifts. Thus, the only restrictions imposed by Congress on unitary holding companies were aimed at ensuring the continued focus by the thrift subsidiary on the traditional home financing function.

The unitary holding company structure has worked well to date and serves as an important source of capital infusion to the industry, by enabling holding companies to conduct a diversity of activities that lend strength to their subsidiaries, and by permitting different types of companies to acquire thrifts. As the chief federal regulator of the savings and inquiry on my part, that the current unitary holding company structure has led to abuses that would warrant the kind of significant legislative change being proposed to this Committee.

Opponents sometimes point to the greater diversity enjoyed by thrift unitary holding companies when compared with bank holding companies. However, at the risk of being redundant, this difference specifically reflects Congress' longstanding recognition of the need to supplement the limited asset authority of thrifts and of the fact that, because of the limited commercial asset powers of thrifts, ownership does not raise the credit allocation issues present in the ownership by commercial banks of commercial enterprises. Given these differences, we can see no basis for emasculating unitary savings and loan holding companies by removing their current flexibility in favor of the more limited "laundry list" afforded multiple savings and loan holding companies. There is no justification for this charge, if the goal is to truly balance the authorities of the bank and thrift industries.

Clearly, scaling back the options of thrift holding companies in such a drastic way as you propose would make thrifts far less attractive to the capital markets and to investors. Any reduction of thrift asset powers, or a significant diminution of structural flexibility, would seriously undermine the ability of thrift institutions to generate counter-cyclical earnings streams to offset interest rate swings. Given the Congressional mandate that thrifts maintain their commitment to

housing lending thrifts, unlike banks, are uniquely susceptible to the cyclical nature of housing demand and to the dangers of interest rate risk. By depriving thrifts of important asset powers and structural "elbow room" to balance their portfolios through affiliation with unitary holding companies, the proposal you have suggested would have the effect of driving thrifts toward the same asset liability mismatch trap that nearly proved fatal to the industry during the last several years.

And any reduction in the structural flexibility of thrifts would diminish the value of a thrift charter. This could impede the valuable mutual-to-stock conversion process, or, at the very least, diminish the amount of capital that may be raised in conversions.

We believe such changes could translate into a "domino" effect of negative consequences for the industry: reduced capital invested, leading to lower thrift net worth, increased pressure on the FSLIC insurance fund, and increased federal expenses to stave off failures. We believe such results must be avoided by leaving the current powers of thrift holding companies intact.

Finally, notwithstanding our general support for retaining the unitary option, the Board does believe that reform is vital in one area — the affiliation of thrifts with underwriters or marketmakers of corporate securities. We believe the most appropriate approach in this regard is set out in S.759, which would impose an explicit ban on such affiliations, with no grandfathering of existing relationships.

QUESTION 3:

The net worth certificate program was originally designed to help institutions overcome a temporary interest rate spread problem. However, most of the problems of the FSLIC in the next year or two seem to concern credit risk rather than interest rate risk. There is no way a net worth certificate program can help an S&L recover from making too many bad loans. If this is correct, why do we need any net worth certificate program at all? Why don't we simply let the program expire?

ANSWER 3:

While credit risk problems are coming more to the forefront, there still exist many institutions which continue to suffer from interest rate spread problems. Spread problems cannot be solved overnight, even with a continuation of lower interest rate levels. These institutions will need a significant period of time or restructure their asset portfolios to the point necessary to reach a stable and profitable position. The Net Worth Certificate Program provides an opportunity for such restructuring and allows the participating institutions to continue to serve their communities. Indeed, absent the program, many of the participating institutions would have ceased to exist as independent entities.

The program has the added benefit of reducing the possible exposure to the FSLIC fund. I strongly urge the continuation of the Net Worth Certificate Program.

QUESTION 4:

Can you give us any examples of financial institutions that have successfully recovered after receiving net worth assistance from the Federal Home Loan Bank Board?

Please provide the Committee with statistics on the net worth certificate program, including the so-called Phoenix program. These statistics should indicate the level of capital before assistance, the amount of assistance and the current level of capital.

ANSWER 4:

**Select Institutions Participating in the
Net Worth Certificate Program
as of 5/31/85**

Those institutions that reported net income for their most recent yearend and/or reported year-to-date net income.

<u>District</u>	<u>Name</u>
1	Milford FS&LA
2	First FS&LA of Montclair
2	State Savings, FA
2	Columbia S&LA, FA
2	Llewellyn-Edison S&LA
2	Fellowship S&LA
2	Brooklyn FS&LA
2	Salamanca FS&LA
2	Columbia Banking, FS&LA
2	Shadow Lawn S&LA
2	North Jersey S&LA
2	White Horse S&LA
4	Newton S&LA
4	Druid Hill FS&LA
6	First FS&LA
6	Railroadmen's FS&LA of Indianapolis
7	Shelby FS&LA
7	Peerless FS&LA
7	Charleston FS&LA
7	Capitol FS of America
7	Mendota S&LA
7	Batavia S&LA, FA
7	Horizon FSB
7	First FS&LA of Madison
7	Security S&LA, FA
7	Home FS&LA of Elgin
7	Morton FS&LA
7	Loves Park S&LA
8	Home FS&LA of Harlan
9	First FS&LA of Alexandria
9	Terrebonne S&LA
10	American Charter FS&LA
10	First FS&LA of Coffeyville
10	Nile Valley FS&LA
12	First FS&LA

QUESTION 5:

In an article in the February issue of Savings Institutions, a publication of the U.S. League, Dennis Jacobe notes that some thrift lenders are contemplating a return to fixed rate lending in order to earn the higher immediate spreads on fix rate loans. He concludes by warning that "It would be a terrible thing to see the progress of the last couple of years dissipated and the business returned to fixed rate mortgage lending. Still, we are often our own worst enemy in this business, especially when the high-paid salesmen on Wall Street provide the rationale."

Do you agree with Mr. Jacobe's analysis, and if so, what steps is the Bank Board taking to prevent a return to the discredited "borrow-short, lend-long" strategy?

ANSWER 5:

The Bank Board has noted a favorable trend in the origination of adjustable rate (ARMS) mortgages in recent months. Contrary to popular myth, the fixed-rate mortgage has not reclaimed its former dominance of savings institution mortgage activity. Indeed, the ARM is alive and well and trending upward.

The ARM share of conventional home mortgages on single-family residences made by FSLIC-insured institutions rose to 61 percent in early July, up from 59 percent in early June ;and 52 percent three months earlier. The July ratio was the highest since last November. The continuing dominant role played by ARMS—especially in light of recent declines in mortgage rates—belies the notion that lower mortgage rates make fixed-rate mortgage preferable to ARMS in the eyes of most homebuyers. Seen together, recent profitability; moderate, not excessive growth in the industry; and continued significant emphasis on ARM mortgage originations by thrifts are all persuasive evidence that the savings institutions industry can adapt, and is adapting, to a rapidly changing environment.

Despite the very real difficulties a segment of the thrift industry is experiencing, and the continuing, critical need to reform, strengthen and alleviate strains on the thrift deposit insurance system, the long-term picture for a great majority of thrifts looks brighter today than at anytime in recent years.

Mr. GRAY. You're welcome. Thank you.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Mr. Chairman, last December you proposed regulations limiting direct investment activities by FSLIC-insured institutions.

Why aren't those regulations enough to rein in the problem institutions? Why do you need statutory authority as well?

Mr. GRAY. You're referring to a special risk premium?

Senator GORTON. Yes.

Mr. GRAY. Well, the risk premium would—

Senator GORTON. And to the ability to deny FSLIC insurance to institutions that don't meet community needs.

Mr. GRAY. I'm sorry. I don't understand the question.

Senator GORTON. Well, you're requesting authority to deny insurance to institutions that don't meet community needs. What you are saying, I assume, is that you do not feel that you have enough regulatory authority now to do by regulation what you propose for us to do by statute.

Mr. GRAY. You're talking about State-chartered institutions having to demonstrate a need for the Bank Board to consider them for approval for insurance of accounts?

Senator GORTON. Yes.

Mr. GRAY. Well, let me give you an anecdotal example of what I came across the other day in talking with a particular State commissioner. He said that there were eight savings and loan institutions in a shopping center, eight of them, storefront savings institutions, all of them State-chartered. A supermarket had been withdrawn and the only thing left in the shopping center was something like a dry cleaning establishment and something like a Seven-Eleven. So we have eight savings institutions operating in a particular area and the question arises, as to whether all of these applications should be provided insurance of accounts.

INADEQUATE STATE SUPERVISION

What does that do for the rest of the industry? Does it provide any additional source of funds for housing? We observe in one State after another that these States do not have adequate examination and supervisory resources. That is a fact. It is a fact compared to our resources and ours right now are inadequate. So we receive more and more of these applications for insurance of accounts from applicants in States having inadequate supervisory and examination resources to supervise and examine their own State-chartered institutions. The dual banking system, it seems to me, mandates that there is a responsibility for States to provide for adequate examination and supervision resources if they want to charter and regulate their own institutions.

So that is another factor that really ought to be taken into account. It is ancillary to what you asked.

Senator GORTON. It is ancillary to what I asked. It's an interesting answer, but my question was: How much of what you propose to do by statute do you feel you have the authority to do by regulation now?

Mr. GRAY. In the case of State-chartered applicants for insurance of accounts, a demonstration of need is not required, whereas, for federally chartered institutions, it is. And we believe that with—

Senator GORTON. What about regulations that limit the kind of business or investment which insured institutions can make? You don't think you can provide such a limit by regulation?

Mr. GRAY. The regulation that we adopted in late January which provided for the establishment of this threshold for direct investments was not a limit at all. It was merely a threshold, a supervisory review threshold, if you will, but in no way did it prohibit State-chartered institutions from exceeding that threshold if they had adequate levels of capital, good management, good track records, and were not undue threats to the FSLIC.

And let me just say that in the case of the need requirement, a court decision has held that State-chartered institutions did not have to demonstrate that there was a need in the community. However, that requirement continues to exist for federally chartered applicants.

Senator GORTON. Let me try a very similar question in a slightly different fashion. You seek for the Bank Board statutory authority to restrict the activities of insured savings and loan associations. You already have general authority to restrict activity which poses a threat to the insurance fund and I presume that you find that inadequate and that's why you are here asking for more authority.

Is this because it's impossible for the thrift examination system to identify individual institutions whose behavior will threaten the insurance fund in a timely fashion, or is it because your legal enforcement tools are inadequate, or is it both?

Mr. GRAY. We could use additional enforcement authority and we have asked for some in the legislation that we have proposed.

What happens is that an institution in a deregulated environment can access tremendous amounts of money. We saw this when brokered funds were being relied upon as the primary source of funds. Then these funds are invested or loaned, oftentimes too quickly, and that is one of the primary reasons why we have failures resulting from severe asset quality problems in too many institutions. These investments are made before we have an opportunity to discover the problem.

We generally examine institutions anywhere from 1 year to 18 months and we monitor institutions monthly, but it is very, very difficult for us to find out until it's too late that heavy financial losses have occurred. This is one of the reasons the Board proposed and adopted the direct investment regulation which established supervisory thresholds, so that before there were serious losses we would at least have an opportunity at a threshold level to the kinds of direct investment and activities an institution sought to pursue above and beyond that threshold.

Senator GORTON. Is the FSLIC decision to operate Beverly Hills Savings & Loan until it can be sold without assistance motivated by a desire to avoid an insurance fund payout?

Mr. GRAY. In that particular case I think it is an effort to bring in strong management, and we do have good management resources in the savings and loan business, so that we are able to get a better handle on what exactly is going on in the institution

before we go out for bid. When the institution is stabilized, hopefully, we will seek a serious acquirer or as a last resort will seek to liquidate the institution.

Senator GORTON. At this point you don't know which of those courses of action is more likely?

Mr. GRAY. Well, I think it's a good interim procedure to follow because this industry has a great deal of expertise which can lend itself to institutions that are in a distressed condition, particularly at a time like this when the institution has become insolvent.

NET WORTH CERTIFICATE PROGRAM

Senator GORTON. When the Net Worth Certificate Program was created in 1982 to assist savings and loans, it was done on the understanding that the asset quality of those associations remain strong and the problem was to work out of an interest rate mismatch and you referred to this in your direct testimony.

Mr. GRAY. Right.

Senator GORTON. Two weeks ago the FDIC testified before this committee that net worth certificates should not be extended to agricultural banks because their asset quality problems were fundamentally different in nature from the S&L interest rate mismatch problems and could not be resolved by buying time.

Now on page 13 of your statement today you state that "a very substantial portion of the current FSLIC caseload is characterized by bad assets." I think 70-80 and it was close to 20-30 before.

Does this mean that we should rethink reauthorizing net worth certificates when they expire in September or impose some kind of restrictions on their use?

Mr. GRAY. Essentially, in order to qualify for net worth certificates insured institutions must have an asset/liability mismatch. So I think the Net Worth Certificate Program should be extended because I think it does serve a useful purpose for those institutions which qualify.

Senator GORTON. For the mismatch institutions?

Mr. GRAY. That's true and that's what it's used for.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

First, let me say, Chairman Gray, that I appreciate the work that you have been doing. I know this has been a very turbulent time in the industry and a lot of effort has been required and I appreciate the effort that is being made to try to strengthen the industry and I very much support your strong emphasis on the housing finance aspect which really keys much of your statement today.

You have made a number of important suggestions which I know the committee will consider carefully. I want to get into two areas in this first round, first, an overall sizeup.

I'm wondering if you can give us your best description of what you see as the overall strength, or lack of strength, in the savings and loan industry at the present time. Where are we now? Interest rates have come off some and presumably that is helping some of this mismatch problem, but where do we seem to be in terms of the

overall strength of the industry at this time and where do the trend lines seem to be taking us?

Mr. GRAY. I think we are going to have a very good year, a very profitable year in the savings institution industry. We have many very strong institutions. Unfortunately, we have a relatively small percentage of institutions that are either hopelessly insolvent or are on the way to becoming hopelessly insolvent. That is, a FSLIC problem which requires financial assistance to consummate a merger or an acquisition. There are too many coming on line because of excessive risks being taken by some institutions, kind of a heads I win, tails the FSLIC loses mentality.

So generally speaking, the industry I think will have a good year this year if interest rates hold at the level that they are now, but we continue to have the problem of inadequately capitalized institutions taking excessive risks, and this is why we have specifically proposed the risk premium which will help us deal at the FSLIC level in better underwriting the risk of loss.

But I would say that in contrast to 1981 through 1984, we can look forward to, a good year.

Senator RIEGLE. Is that the same thing as saying that the number of institutions on the problem list is declining, holding steady, or what are we seeing with respect to that?

Mr. GRAY. In absolute numbers?

Senator RIEGLE. Yes.

Mr. GRAY. Unfortunately, I would have to say the number is creeping up.

Senator RIEGLE. So the strength we are seeing then is not evenly distributed?

Mr. GRAY. No.

Senator RIEGLE. We're seeing somewhat greater strength in some institutions which would improve the picture but we are still seeing some kind of gradual worsening in the overall industry at least in terms of numbers that are coming on the problem list. Is that right?

Mr. GRAY. I don't think I would characterize it that way. I would say—and I don't like to use percentages for obvious reasons in a public forum, but I would say—and I would be happy to provide this in more detail on the record—that a significant but relatively small number of institutions compared to the overall size of the industry that are not improving and do not appear to have very much, if any, possibility of coming out of this. Again, we have to deal with that through the FSLIC.

But overall, generally speaking, for this year, I do believe we are going to have a good year and probably by far the best year, if interest rates hold, that we have had in 3 or 4 years.

STRENGTH OF THE INSURANCE FUND

Senator RIEGLE. How does your insurance picture look? I know you're talking about changing the premium structure, but at the moment how do we look in terms of the strength of our insurance cushion at this point?

Mr. GRAY. Well, I think we have adequate strength in our thrift insurance system today. What we want to make sure of is that we

have that strength next year, the year after, and the year after that. There has been a continuing decline in the ratio of FSLIC reserves to liabilities. That is down now to 27 or 26 percent. It was about 20 when we began to reach a position where an additional premium may be required. The Board exercised its authority to increase the premium on insured institutions on a special basis. I do not believe that will be adequate. I believe that there must be far more emphasis on the part of the industry, those of us at the Bank Board and you in the Congress to work together to find a way to replenish the reserves and stabilize the FSLIC, not merge it with the FDIC. That doesn't solve any problem at all.

Senator RIEGLE. What would you think of the idea of limiting the deposit insurance to that ratio of the assets of the institution that are under the form of federally approved activities so that if an institution out in a State was 70-30 in terms of 70 percent of the activities being ones that the Federal Government would authorize and the other 30 being additional powers granted by the State, the deposit insurance coverage in that case would be 70 percent? In other words, there would be a sliding scale which presumably would be publicized. This is a different way at getting at your risk premium so at least the public, the depositor could make an informed judgment. If they wanted to get into a situation where you were in the broader range of State functions and perhaps the risks and the interest rate premiums being offered were higher and the Federal insurance was lower, then at least you would be protecting the Federal taxpayer more directly and not exposing the Federal taxpayer to a higher degree of risk in those State-offered functions.

Mr. GRAY. Let me understand what you're saying. You're saying that the insurance of accounts would be less?

RATIO BASIS OF 70-30

Senator RIEGLE. You would do it on a ratio basis. You would say that if the assets of this institution are employed 70-30 and 70 are in Federal-type functions, that the Federal insurance in the case of a failure would be 70 percent. In other words, you would only insure the federally granted powers. If an institution wants to move away from that, they do so and one of the things they surrender is the element of Federal protection for that aspect of State-granted activities.

The CHAIRMAN. If I could interject, what you're talking about then is \$70,000 in the example you used would be the maximum insurance they had rather than the \$100,000?

Senator RIEGLE. That assumed that that bank was employing 70-30 in terms of its asset base. What I'm wondering about is how do we inform the depositor? I want to keep the Government out as much as possible, but I want the information and the risk of the Government put in a form where the public really knows what's happening and a person has a way to make an informed deposit judgment; I'm worried about the safety and soundness issue, as you are.

Mr. GRAY. Sure. Well, in all honesty, I have not encountered this particular concept and I would like to think about that somewhat more and not make a precipitous judgment.

Senator RIEGLE. You see, there's a real question in my mind that we are seeing a breakout of more functions or higher risk functions and they are really outside the scope that the Federal deposit insurance was really designed to deal with.

Mr. GRAY. Right.

Senator RIEGLE. And it seems to me perhaps one way to establish a fair and square discipline is to say that Federal deposit insurance covers those functions that the Federal Government intends for an institution to be involved in and anything beyond that, if the State wants to grant additional powers, would be insured by the State. It seems to me we ought not to allow sort of a willy-nilly expansion of the Federal deposit guarantees.

Mr. GRAY. Well, I would like to think about that a little bit more. It is, in some sense, the same kind of thing that we are trying to get at in the risk premium, but it goes at it in a different way.

Senator RIEGLE. If I may just pursue it one step further, it seems to me that if you're running a savings and loan in a more adventuresome environment and you're bridging out in Arabian horses or some of the other things that you cite, the public should understand through the deposit ratio that they were getting into a situation with greater risk. But I have a hunch that the public has been sensitized now by Ohio and Maryland to such an extent that people really want to believe and feel that that Federal deposit insurance is really solid as a rock and I want it to be, although I'm uneasy about the fact that the deposit reserves are dwindling and we are in a situation where interest rates have come down and so they're easing some of the stress in the industry but that could be a temporary phenomenon. I think we've got to find a way to let the public understand better the risks associated with different institutions and we can't have the Federal Government sitting here prepared to bail everybody out. I'm talking about managements that go beyond prudent balance and way beyond the scope of what the Federal law actually envisioned.

Mr. GRAY. Let me just say that I would like to—and I assure you that I will carefully consider this concept which is new to me which seems to move in the same kind of direction. Of course, as you know, we have proposed the risk premium that we believe would enable us to basically protect the fund in the same way by providing a premium commensurate with the risk of the activity involved.

Senator RIEGLE. But does that inform the public directly?

Mr. GRAY. No.

Senator RIEGLE. I might say, it might not necessarily have to be the 70-30 split. Maybe you can give the State 10 percentage points or something where they are allowed to exercise State powers but beyond some threshold limit you then start to rein in the deposit insurance guarantee.

Mr. GRAY. There was some talk last year by some States who were worried about the thresholds investment who proposed to establish their own insurance fund, but I saw frankly no State breaking down the doors to establish their own insurance funds. With the problems in Ohio and Maryland with private deposit insurance, I think everything has gone in the other direction.

Senator RIEGLE. Thank you very much.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Chairman Gray, it's nice to see you. Many of my questions have been answered but one big question I have right now is philosophical to you.

Last week the Senate passed a budget reduction program and it's now in the House. If the House adopts it, it has been estimated that interest rates will drop 2 points. What would that do to your industry?

TREMENDOUS SHOT IN THE ARM

Mr. GRAY. It would be a tremendous shot in the arm to our industry to see interest rates go down 200 basis points, absolutely.

Senator HECHT. Better than any legislation or any regulation we can give you; right?

Mr. GRAY. I would put it at a par, if that would actually be the case.

Senator HECHT. You mean if interest rates do come down?

Mr. GRAY. That would be very, very helpful.

Senator HECHT. Well, the financial markets feel this way and the economists feel this way, which troubles me because they have always been wrong since I've been in Washington.

Second, you come from out West and I do too, and the second family homes are a big part of the West and I see it in the East, too. The construction industry and the home building industry is a big part of our economic recovery.

What's your feeling on the interest deduction on second family homes?

Mr. GRAY. For the second home?

Senator HECHT. Second home, yes.

Mr. GRAY. Well, that is a loaded question and I frankly am not that familiar with the inner workings of some of these tax proposals that are reported.

Senator HECHT. Treasury II hasn't come out yet so you can talk about it even knowing that it's coming out, but this interest deduction on the second home is a big part to the home building industry.

Mr. GRAY. Sure.

Senator HECHT. What do you think about it?

Mr. GRAY. I think I'd rather leave that up to the Congress to decide. The Congress has a complex problem it seems to me in trying to deal with the budget deficit. How the Congress chooses to do that is something in its collective wisdom it can do far better than I. If you are saying that it would be better for the home building industry to have that interest deduction for the second home, I would say, yes, it would; yes, it would.

Senator HECHT. Thank you very much. No further questions, Mr. Chairman.

The CHAIRMAN. Senator Dixon had to leave for another committee and asked unanimous consent that his statement be included before we started the questioning period.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its oversight hearings on issues concerning the financial services industries. I look forward to the testimony of the distinguished witnesses appearing before the committee today.

The pace of change in financial services is quite rapid. New technology, regulatory reform, and changes in the economy, have all helped accelerate the pace of change in the marketplace. Our statutory framework, however, has not kept pace with this change. Its basic structure was laid out many years ago.

In 1982, this committee took an important step toward updating Federal law by acting on the Garn-St Germain Act. Last year, the committee took another step and reported and achieved Senate passage of comprehensive banking legislation. Unfortunately, however, that bill was not enacted.

It is vitally important that we promptly address the issues raised in that bill, and additional issues that have arisen since it was enacted. In that respect, I recognize that there are some very important issues that were not addressed in last year's bill, and I believe they should receive the committee's careful consideration.

However, as I stated before, I believe that the committee should act on a bill similar to last year's as rapidly as possible in order to put the maximum pressure possible on the House to begin serious consideration of broad legislation. Other issues, while no less important, should be handled in separate bills. I look forward to working with my colleagues on the committee on a strong and meaningful banking bill that we can get enacted this year.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Gray, given the situation which has developed in Maryland, it's opportune to have the benefit of your testimony this morning and to have the opportunity to discuss with you the prospects for the Nation's savings and loan institutions.

Those thrift institutions have traditionally played a central role in our economic financial system, as you pointed out in your opening statement, and obviously it's essential that the necessary steps be taken to reinforce their stability and to assure our citizens' confidence in them.

SITUATION IN MARYLAND

With respect to the situation in Maryland, it's essential, in my view, that officials of the Federal Reserve Board and the Federal Home Loan Bank Board work closely with responsible State officials to reach these goals. I understand that this cooperative effort is proceeding.

Mr. GRAY. Yes, it is.

Senator SARBANES. And there was a story, for instance, in this morning's Baltimore Sun that the Federal Home Loan Bank Board stated yesterday that it would act swiftly to process any Maryland applications for FSLIC coverage. Your Board spokesman stated that applications for Maryland institutions would be processed as expeditiously as possible.

Given that, I think it would be helpful to have your assessment of the current situation in Maryland, and a summary of the actions of the Federal Home Loan Bank Board and the FSLIC are prepared to take in this situation.

Mr. GRAY. Well, again, it is very difficult for us to know very much about the savings institutions insured by the Maryland insurance fund because we have never had any involvement in regulating or supervising those institutions.

I did receive a call this morning shortly before coming here from Governor Hughes. He asked me to assist in any way that we can in expediting applications for insurance of accounts that come from those institutions that wish to apply for our insurance. I told him that we would, just as we did in Ohio, and I must say that we acted with lightning speed—unprecedented lightning speed to process those applications. We will do it again.

As of this morning, in a conversation I had with representatives of the Federal Reserve, we are coordinating very closely with their examiners, with our Federal home loan bank in Atlanta and our principal supervisory agent there. We have been mobilized for 1 week. We have been talking to representatives of the Governor's office for nearly 2 weeks at the staff level, and we are planning today to move very, very quickly to send examiners in. They will be Federal Reserve examiners, FDIC examiners, Comptroller of the Currency examiners, and as many as we need to move very quickly into these institutions that seek insurance of accounts from the FSLIC.

I expect, as a result, we will be able to move as quickly as we did in Ohio.

Senator SARBANES. As I understand it, a significant team of Federal examiners is coming into the State, drawn from all the Federal regulatory institutions in the financial field; is that correct?

Mr. GRAY. That's true.

Senator SARBANES. From the Federal Reserve, from the FDIC and from the Home Loan Bank Board?

Mr. GRAY. Really as many examiners as are necessary will be made available.

Senator SARBANES. It might be helpful if you outline for the record the steps an institution takes when it seeks to enter the FSLIC system, and what criteria are applied to the application.

Mr. GRAY. Well, let me begin by answering from the law of the National Housing Act. I want to make sure you understand what that act requires of us. It says:

The FSLIC shall reject the application of any applicant if it finds that the capital of the applicant is impaired or that its financial policies or management are unsafe and the FSLIC may reject the application of any applicant if it finds that the character of the management of the applicant or its home financing policy is inconsistent with economical home financing or the purposes of this subchapter, and in considering applications for such insurance the FSLIC shall give full consideration to all factors in connection with the financial condition of applicants and the insured institutions and shall have the power to make such adjustments in their financial statements as the corporation finds to be necessary.

What we have required over some period of time now is that an applicant meet a 5-percent net worth test—that is what we call snapshot net worth—reserves to liabilities, and then we also require that the institution agree to maintain that 5-percent net

worth which seems entirely appropriate to us, particularly given the fact that we require a 7-percent snapshot net worth entrance test for de novo institutions seeking insurance of accounts. So that is one of the tests that we use.

We also subject these applications to a viability test to assure that under given general economic scenarios the net worth of the institution is not expected in a 5-year period to drop below 3-percent net worth.

We take into account the quality of the management assets. We look at all of those factors as required by the statute, and then as in Ohio, we moved very quickly, in some cases in a matter of 4 or 5 days.

Senator SARBANES. I was going to pursue that point. I understand that in the Ohio situation you were able to cut down significantly on the time period that the application process ordinarily takes. Is that correct?

Mr. GRAY. That's correct. I have to say to you—and I wish I didn't have to say this to you—but generally speaking, it took months to accomplish this kind of processing before. But when we encounter these kinds of situations which I believe the public interest dictates that we expedite them that does not mean to say that we are sloppy or incomplete. That means that we, in cooperation and as a team with these other agencies, look very carefully at the institution and are able to move very quickly.

One of the reasons why we have not been able to do that so quickly, Senator, in the past is frankly because we have been understaffed in our examination force out in the field and this is one of the reasons why we are requesting the cooperation of other Federal agencies.

Senator SARBANES. I take it, therefore, that you expect to be able to move with comparable speed in the Maryland situation as these examinations proceed and as the applications are received.

Mr. GRAY. Yes, assuming we have an application. Obviously we have to have the application.

Senator SARBANES. Are you satisfied that the S&L institutions in Maryland are fully cognizant of the process if they should wish to go into the FSLIC system?

FSLIC BENDS OVER BACKWARDS

Mr. GRAY. Let me say that in the Ohio thrift situation, we bent over backward. We took the initiative to apprise all institutions of all of our requirements. The same thing is happening now with respect to Maryland.

Senator SARBANES. Do you also work with the institutions to bring them up to the requirement standard if for one reason or another they should fall short of it? Does Bank Board personnel provide counsel and advice on how to reach the standard?

Mr. GRAY. Yes, sir, if possible. We suggest essentially a range of alternatives that are available to an institution such as the use of subordinated debt. There are a number of vehicles that can be used by some institutions. I'm not saying this would apply to all of them. It would depend on the condition of the institution and it is possible that the State may decide—and this would only be specula-

tion on my part—the State might decide to take some measures on its own part to help those institutions. But that would be a matter for the State.

Senator SARBANES. Mr. Chairman, I see my time is up. I simply want to underscore again, as I did at the outset, how important it is that the whole range of officials involved, both at the State and Federal level, continue to work very closely together in order to reinforce the stability of these institutions and to reassure the people who have placed their confidence in them. I welcome the testimony from the Board that they are doing exactly that and the story in this morning's paper that they are standing ready to act in a very expeditious manner with respect to applications from Maryland institutions for entry into the FSLIC.

Mr. GRAY. And we will meet that commitment.

The CHAIRMAN. Again, Mr. Bergman who will testify in a little while says that that National Association of State Savings and Loan Supervisors supports interstate branching for thrift institutions. Mr. Bergman also says that NASS&LS recommends that the Federal Home Loan Bank Board promulgate a regulation crafted in a fashion which would condition the ability of a federally chartered thrift institution to branch interstate upon the certification by the State regulator that the State law permits the entry of out-of-State institutions.

How do you respond to that suggestion?

Mr. GRAY. Mr. Chairman, I believe that is already happening in reciprocal agreements that some States have. The question of interstate branching for thrifts is an interesting one.

The Garn-St Germain Act, of course, in 1982, provided the means by which the FSLIC can solve some of its problems by rewarding with interstate rights an institution which was willing to help us by picking up a distressed institution in another State.

Even though there has been a decision by a Federal judge I am very concerned about the proliferation of this trend to nonbank banks. The Bank Board has long had the authority to allow interstate branching. We have chosen not to allow it—except to the extent that there are reciprocal arrangements—to help solve our FSLIC problem. Until we get our hands around that FSLIC problem I would have some reservations about interstate branching. Any institution which is concerned about the FSLIC, their own insurance corporation, it seems to me would have that same kind of concern.

The CHAIRMAN. Mr. Gray, I have additional questions but due to the fact that we have two additional witnesses this morning I will send them to you for your response in writing.

Senator D'Amato was here earlier, as was Senator Dixon, and he had to leave for another committee. He also has a statement and some questions which he would like for you to respond to.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. Today, we will continue to hear testimony regarding the health and stability of the financial services industry. Mr. Chairman, I would like to commend you on conducting this set of hearings and I also would like

to welcome the distinguished panel of witnesses here today. I understand the schedules these gentlemen have and I appreciate their taking the time to join us to testify on this important topic.

Over the past several months this country's financial services industry has shown a certain instability it has not shown for over 50 years. It is not an uncommon occurrence if today you were to pick up your local newspaper and read of another bank failure or of another country which is having difficulty repaying its loans to American banks. The increase in woeful financial news has served to create a growing fear among the public of whether the system is truly safe.

There is a general feeling by those concerned with the industry that something must be done. I believe this set of hearings provides the proper forum for pertinent and relevant information to be heard. It is my hope that this information can be used to help us cure the current problems in the services industry.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman. I have only two items to cover and I'll try to do it as quickly as I can.

Chairman Gray, you commented earlier about Chairman Isaac's statement last week that he supported the merging of the FDIC with the FSLIC in order, in his words, to strengthen the Federal insurance system.

I know you feel and you said today that you think that is not a wise course, and I think it's important for us to have on the record your specific reasons for objections to that.

REASONS FOR SEPARATE SYSTEMS

Mr. GRAY. Well, I thank you for the opportunity, Senator. I would note here that I spent almost 2 years as a member of the Vice President's task force on regulatory reform and there was unanimous agreement by all the members, including Mr. Isaac and others—Secretary of the Treasury, Mr. Volcker, the Vice President—that:

The Federal Home Loan Bank Board should be retained and expanded to regulate all traditional thrifts as well as banks with an equivalent thrift portfolio that desire thrift regulatory treatment. The FHLBB should continue to operate the Federal Home Loan Banks and the FSLIC.

This is why I mentioned in my opening statement that there apparently was a lapse of memory because I see the signatures of all of those members on this to not merge the FDIC and the FSLIC. I signed that in good faith. I assumed everyone else did.

In addition, it seems to me the idea that we have heard since I have been Chairman, going back to 1983, that we ought to merge these funds is merely a crutch. It does not solve any problem whatsoever. It does not bring into our system a greater degree of discipline to confront directly our problems.

I don't see how it would help the FDIC either, and so it seems to me that there is absolutely no constructive purpose served in talking about merging two insurance funds. I believe that we have the capacity ourselves in the savings institutions industry, working

with the Bank Board and with the Congress, to address these problems.

Second, the FSLIC is the cornerstone of the Federal Home Loan Bank System and is part and parcel of the National Housing Act. So to say, that the savings and loan institutions have really become commercial banks now and therefore we should place them all under one giant Federal regulatory umbrella and we ought to do the same thing with the insurance funds just serves no purpose. What purpose would it serve today any more than whatever purpose there was for this notion 2 years ago?

The best way for us to confront our problems is to try to institute the kind of discipline we need to look for our own solutions and not to seek for alternatives that would certainly increase disruption for all financial institutions. We can do it and there is absolutely no need at this time to even be talking about it. It serves no good purpose whatsoever. It solves nothing.

Senator RIEGLE. Let me ask you one other thing. That is, with the Federal deposit insurance it's the Federal taxpayer that's ultimately responsible for the problems that arise in the federally insured institutions. My question is, Who backs the State-chartered institutions that are privately insured and what changes would you recommend regarding our Federal and State deposit insurance programs?

Mr. GRAY. Well, I have come to the conclusion that all depository institutions ought to be federally insured. Those that can qualify ought to be federally insured. We have gone through the Ohio situation and it is not a conclusion that I have reached without a good deal of thought.

My other problem is that for FSLIC-insured institutions, that are authorized certain powers which we have to underwrite for risk of loss—there has to be a more rational means than our group insurance plan to underwrite this risk of loss.

That's why I suggested earlier the risk premium, because I think it's something whose time has come. Remember, every legislation that authorizes thrift institutions to do whatever they want well beyond anything that Congress in its collective wisdom has authorized, is held totally and completely harmless from any risk of loss, potential or actual loss. It is the Federal taxpayer in the final analysis that is at risk, and that is my concern; that we find a way—those of us who have taken an oath, who are sworn to uphold the law and our responsibilities to protect the safety and soundness of this fund—to find a way, a more rational way, in this new environment that we are now operating in to deal with the kinds of losses and risk of loss that we are seeing.

Senator RIEGLE. Well, I thank you for those responses. I have some other questions I'm going to submit for the record too, Mr. Chairman.

[Response to written question of Senator Riegle follows:]

Questions for Chairman Gray from Senator Riegle

Question: When Chairman Volcker testified before this Committee he argued that the thrift test should be "strengthened substantially" and advocated that "to achieve the necessary strengthening, the thrift test should, at a minimum, require that at least 65 percent of a thrift's own assets be devoted to home lending." He also said that "it should exclude a 'pass-through' of loans originated and sold to other investors.

At the same time that Volcker was saying this before the Committee, Wall Street investment bankers were telling me that in view of the current plight of the thrift industry, the way to go in their opinion was to allow more, rather than less, diversification.

What is your reaction to these opposing viewpoints?

Answer:

I think that institutions with significant mortgage banking operations are providing a very useful service and that this ought to be recognized in any qualified thrift lender test.

I firmly believe the mission of FSLIC-insured institutions should be economical home finance. I further believe this can be done profitably and prudently. Certainly, I am in favor of diversification. This can be accomplished by holding different types of mortgages, adjustable-rate mortgages with various indices and adjustment terms, consumer loans, service corporation investment of the type permitted for federal associations, commercial loans, and rated corporate debt securities.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I think I would prefer to let Chairman Gray get back to his other duties. [Laughter.]

The CHAIRMAN. Let me just say, Chairman Gray, that we are pleased that you could be here today and I do want to commend you for the assurances that you have given the committee and Senator Sarbanes. I think the Ohio situation was a very good example. We complain so much about the bureaucracy and the inability of various levels in Government to work together. In the Ohio situation we reversed that trend and I'm pleased with your reassurances and I hope people will listen in Maryland. You and the other agencies are willing to work with the Governor and the officials of Maryland. This is a problem which is solvable. The vast majority of Maryland institutions are in excellent shape and no one faces threat of loss. The problem I believe is minimal and I think your reassurances are very helpful. Thank you very much.

Mr. GRAY. Thank you very much.

The CHAIRMAN. Next I would like to invite to the witness table Mr. Sidney A. Bailey, commissioner of financial institutions for the Commonwealth of Virginia; and Mr. William S. Bergman, the executive vice president of the National Association of State Savings and Loan Supervisors.

Mr. Bailey, we are happy to have you before us again, if you would like to begin.

STATEMENT OF SIDNEY A. BAILEY, COMMISSIONER OF FINANCIAL INSTITUTIONS, COMMONWEALTH OF VIRGINIA

Mr. BAILEY. Thank you.

Mr. Chairman, members of the committee, I am Sidney A. Bailey, commissioner of financial institutions for the Commonwealth of Virginia and past president of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

FAVOR CLOSING NONBANK BANK LOOPHOLE

Closing the nonbank bank loophole remains our top priority, notwithstanding any changed circumstances since the last Congress.

Through the nonbank bank mechanism, the Bank Holding Company Act of 1956 is being used to achieve exactly what it was designed to prevent. As the U.S. Supreme Court recently set out, the act was enacted to accomplish two primary objectives:

* * * it was designed to prevent the concentration of banking resources in the hands of a few financial giants.

and,

* * * it was intended to implement a congressional policy against control of banking and nonbanking enterprises by a single business entity.

As the court noted,

* * * underlying both objectives was a desire to prevent anticompetitive tendencies in national credit markets.

Presumably, under our system of government, Government interference with the private sector is undertaken only when necessary and cost-beneficial. In this manner we seek to maximize productivity.

ty on the private side and maximize benefit per dollar spent on the public side.

Banking is a regulated industry. Why? What caused the Members of Congress who walked these Halls before you to decide that there was a need for regulation and that the system they were fashioning would operate in a manner which would generate a net public benefit? Obviously, there were some specific factual situations which have changed and which we now have the luxury of viewing in historical perspective. But there were several overriding public concerns, more general in nature, which transcend the specific facts of any given point in time.

The Bank Holding Company Act represents an effort to control the mixing of banking and commerce and to prevent undue concentrations of economic power. As such, it is a continuation of themes which are found throughout the history of bank regulation. The act provides for measured deregulation of the banking industry in areas beyond traditional banking services. It was congressional response both to the need for some service expansion and to the feeling that there was danger in moving too quickly or too far in the areas of permissible bank holding company activities and corporate ownership of financial institutions.

The section of the act pertaining to nonbanking activities of bank holding companies represented the tradeoff between the two above identified public interests. It delineates the standard for permissible nonbanking activities and, thereby, limits the ownership of banks by corporations engaging in nonbanking activities. The overriding public interest concerns were written right into the act. These are: Public interest in a stable, risk-insulated banking system—safety and soundness; public concern over the undue concentration of financial resources; public benefit derived from the promotion of competition and the avoidance of longer term anti-competitive tendencies in our credit markets; and public interest in avoidance of conflicts of interest, in the unbiased distribution of credit and other consumer safeguards.

Unless the expansion of nonbank banks is halted, there can be little doubt that the fundamental policies embodied in the act will be severely eroded or destroyed. If our congressionally designed system of bank regulation is in the public interest, then its circumvention stands alone as a public harm. Nationwide systemic harm, in itself, should be sufficient to compel Congress to intervene at this point.

Mr. Chairman, CSBS believes that enactment of a loophole closing bill is clearly in the public interest and will support you in your efforts to enact such legislation, as we supported your efforts in passing of S. 2851 in the last Congress. There is a need for an immediate restatement of congressional policy in the area of nonbank banks.

The conference also strongly supports clarification of the scope of State authority to permit interstate bank ownership by bank holding companies, as was contained in S. 2851.

The conference strongly opposes the preemption of State authority to determine bank structure, reserved to the States by Congress in the McFadden Act and the Douglas amendment to the Bank Holding Company Act. We oppose such preemption notwithstanding

ing that it may be done in steps, or that it may be triggered by some State action, or that it may have a time delay. States have responded to the evolution of the banking system in a manner consistent with the intent of Congress in delegating authority over structure to them.

The reasons for which a decentralized system of banking regulation was devised remain valid today. Undue concentration of economic power is a serious threat to our national common good. Decentralization of control over financial resources is the best means of ensuring against undue concentration of economic resources, of promoting competition, of avoiding conflicts of interest, and of ensuring that all sectors of the economy and all geographic areas are adequately and equitably served by financial intermediaries.

Every State that has acted to specifically permit interstate bank acquisitions has limited or conditioned that authorization in some manner. The conditions and limitations which States have imposed are based on the same public interest considerations which caused Congress to create a decentralized banking system. It is absolutely necessary that States have the ability to place conditions and limitations on their authorizations, in order to provide the effective safeguards which Congress intended. States are acting in the public interest. Legislation designed to clarify the authority of States would be helpful, while legislation which included an automatic trigger is not in the public interest.

LABORATORIES FOR EXPERIMENTATION

One of the great strengths of the dual banking system is experimentation. States can act as laboratories for new ideas without putting the whole nationwide system and the public interests underlying it in jeopardy. Here you have a wonderful opportunity, since the approaches taken by States vary widely. You have control States and several variables to observe. If you reserve the right to decide at a point in the future, you can throw out the bad and keep the good. You may opt for no interstate, for regional interest, for full interstate or, hopefully, for continuation of a decentralized system in which each State decides for itself.

CSBS opposes broad preemption of State authority over the powers of State-chartered nonmember banks. As introduced, S. 2851 dealt fairly with States, limiting their ability to export powers beyond those of bank holding companies. As amended in committee, by Senator Dodd, it constituted an unprecedented and unjustified preemption of the authority of States to regulate within their own borders. CSBS strongly opposes this incursion into State authority under the dual banking system at the behest of an industry which has for years benefited from the reservation of authority to States under the McCarran-Ferguson Act.

The conference supports the use of unmanned electronic funds transfer systems to deliver better customer services.

However, we believe that a balance must be struck between public interest in the expansion of service provision and public interest in safeguarding the competitive equality of local institutions and avoiding concentrations of power. Public interests in ATM location and function closely parallel public interest in bank branch-

ing as embodied in the McFadden Act and the Douglas amendment to the Bank Holding Company Act.

However, the U.S. Court of Appeals for the Second Circuit was recently called upon to apply the principles embodied in the McFadden Act to shared ATM networks. That court held that—

* * * a national bank's usage of a shared ATM which it does not own or rent, does not constitute the establishment and operation of a branch under sections 36 (c) and (f) of the McFadden Act.

The court emphasized the phrase "establish and operate" in section 36(c) rather than the functional definition in section 36(f). In essence, it found that although an ATM may be by definition a "branch" of a national bank, its usage did not constitute the "establishment and operation" of a branch under the section which makes State law applicable and limits their interstate placement.

By giving deference to the arbitrary distinction between ATM's owned or rented by national banks and those simply used by national banks for banking transactions, the court ignored both the prohibition on interstate branching and the deference to State law which are fundamental to the McFadden Act.

The principles established in the McFadden Act must be reestablished with regard to ATM's. This must be done in such a way as to permit existing ATM networks to continue to operate. It is important that Congress—not the courts—strike a new balance and apply the public interest tests to emerging technologies such as ATM's.

Congressman Thomas Ridge has introduced a bill on the House side, H.R. 2099, to accomplish these ends. The conference is supporting H.R. 2099 on the House side and we hope that a similar measure might be considered by this body. I have attached those pages of the Congressional Record containing H.R. 2099 and the floor statement of Congressman Ridge to my testimony.

Finally, CSBS recognizes that some expansion of bank and bank holding company roles is necessary to meet market challenges. We have, as a body, adopted a policy which would endorse some expansion of banking powers, following a weighing of public interest considerations. A copy of that policy is attached hereto.

Thank you, Mr. Chairman and members of the committee.

[The complete prepared statement follows:]

STATEMENT OF MR. SIDNEY A. BAILEY

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

RE: LEGISLATIVE PROPOSALS DESIGNED TO
ACCOMMODATE THE EVOLUTION OF THE
BANKING INDUSTRY AND PROTECT THE
PUBLIC INTEREST IN STABILITY,
COMPETITION AND THE AVOIDANCE OF
UNDUE CONCENTRATION OF ECONOMIC POWER

MAY 14, 1985

Mr. Chairman, members of the Committee, I am Sidney A. Bailey, Commissioner of Financial Institutions for the Commonwealth of Virginia and Past-President of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify before this Committee and address legislative proposals designed to accommodate the evolution of the banking industry and protect the public interest in stability, competition and the avoidance of undue concentration of economic power.

THE NON-BANK BANK LOOPHOLE

In May of 1983, in testimony before this Committee, I stated that "The number one short-range priority for CSBS is a Congressional solution to the so-called 'non-bank bank' loophole." Two years have passed since I made that statement. Many things have changed, yet closing the loophole remains our top priority.

The non-bank bank loophole lays waste to an entire body of

public interest determinations. This legal aberration allows the circumvention of Congressionally fashioned controls over (1) the mixing of banking and commerce, (2) the interstate deposit-taking capability of money-center institutions, and (3) the concentration of economic power through depository institution ownership. As you know, Section 2 of the Bank Holding Company Act defines a bank as an institution that both accepts deposits available on demand and makes commercial loans. Divestiture of either of these roles allegedly allows the non-bank bank to avoid key aspects of the current statutory scheme while retaining its bank charter.

Through the non-bank bank mechanism, the Bank Holding Company Act of 1956 ("BHCA") is being used to achieve exactly what it was designed to prevent. As the United States Supreme Court recently set out, the BHCA was enacted to accomplish two primary objectives: "...it was designed to prevent the concentration of banking resources in the hands of a few financial giants...", and "...it was intended to implement a Congressional policy against control of banking and nonbanking enterprises by a single business entity." As the Court noted, "...underlying both objectives was a desire to prevent anticompetitive tendencies in national credit markets."

It is commonly agreed that before the regulation of a sector of the economy is undertaken, a public interest need for such regulation must be identified. If such a need is found, the cost of regulation, generally, must be weighed against the public benefit which may be expected to accrue from such regulation.

Then a specific system of regulation should be selected to maximize the public benefit while minimizing the cost. Presumably, under our system of government, government interference with the private sector is undertaken only when necessary and cost-beneficial. In this manner we seek to maximize productivity on the private side and maximize benefit per dollar spent on the public side.

Banking is a regulated industry. Why? What caused the members of Congress who walked these halls before you to decide that there was a need for regulation and that the system they were fashioning would operate in a manner which would generate a net public benefit? Obviously, there were some specific factual situations which have changed and which we now have the luxury of viewing in historical perspective. But there were several overriding public concerns, more general in nature, which transcend the specific facts of any given point in time.

These broader public concerns constitute an appropriate framework within which a system of regulation may be analyzed. And that is what is required in any meaningful discussion of the non-bank bank phenomenon. It is critical to understand that public harms do flow from the circumvention of a system of regulation, if that system of regulation is valid in the first place.

The Bank Holding Company Act (the "Act") represents an effort to control the mixing of banking and commerce and to prevent undue concentrations of economic power. As such, it is a continuation of themes which are found throughout the history of

bank regulation. The Act provides for measured deregulation of the banking industry in areas beyond traditional banking services. It was Congressional response both to the need for some service expansion and to the feeling that there was danger in moving too quickly or too far in the areas of permissible bank holding company activities and corporate ownership of financial institutions.

The section of the Act pertaining to non-banking activities of BHCs, Section 4, both provided the motivation for the passage of the Act and represented the trade-off between the two above-identified public interests. It delineates the standard for permissible non-banking activities and, thereby, limits the ownership of banks by corporations engaging in non-banking activities. The overriding public interest concerns were written right into the Act. The Act directs that the Federal Reserve Board shall consider certain factors in determining whether an activity is appropriate under 4(c)(8):

In determining whether a particular activity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an Affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

The Act was your way, Congress' way, of exercising its responsibility to identify potential public benefits or harms, to strike a balance and to design a system responsive to those policy determinations.

Safety and soundness concerns are at the very heart of

modern bank regulation. Such regulation is designed to maintain public confidence and to govern risk-taking in banking. Deposit insurance complements safety and soundness regulation by helping to maintain public confidence and by insulating small depositors against risk. The public need for stability in our financial system dictated safety and soundness regulation, which has proven to be cost-beneficial. The inclusion of "unsound banking practices" among the "laundry list" factors is explicit recognition of the risks which attend the unregulated mixing of banking and commerce.

Public concern over the undue concentration of financial resources is reflected in both the limitations on the non-banking activities of the BHCs and the structural limitations contained in the Douglas Amendment. Aggregate concentration--the proportion of assets or output accounted for by the largest firms within the economy or some major sector thereof--has long been considered an important indicator of political and economic power. Aggregate concentration of financial resources in particular is to be shunned since the role of money as the medium of exchange for all commodities carries with it inordinate power. Decentralized control of structure provides the primary safeguard against undue concentration of financial resources and regulatory authority over those resources.

It is not as fashionable as it once was to be concerned with the concentration of economic power. The promotion of competition and efficiency in service delivery has been the focus of recent attention, often at the expense of safety and soundness and concentration considerations. In addition, the usefulness of

antitrust laws to prevent undue concentration of economic power has been in decline. Recent relaxation of standards of review, including the decision of the OCC to include in relevant markets many banks and other financial service competitors which merely advertise in those markets, virtually eliminates anti-competitive effect as a consideration in the merger or acquisition of depository institutions. It would be difficult to argue that any bank merger or acquisition was anti-competitive in the newly defined "financial services marketplace." The abandonment of traditional tests for concentration of market share is an additional green light for increased merger and acquisition activity. These developments make it increasingly clear that structural safeguards represent the only effective way to resist the undue concentration of banking resources.

The public benefit derived from the promotion of competition - the avoidance of decreased or unfair competition - is painfully clear. The difficulty is, and always has been, in striking an appropriate balance between short-term enhancement of competition, and avoiding longer-term anti-competitive tendencies in national credit markets. The decentralization of the American dual banking system, highlighted by decentralized control of structure, is a major factor in ensuring competition. Decentralization of authority assures more participants in the market place by ensuring against abuse of the restricted entry requirements. Ease of entry is a major factor in assessing the competitive vitality of a market.

In addition, the choice between national and state charters creates regulatory competition which produces a healthy, pro-

competitive creative tension for market place innovation while providing protection against the competition-stifling effects of overly burdensome regulation. Competition is not promoted over the long run by either the destruction of decentralized control over structure or the enhancement of the market position of only the largest "fail-safe" institutions. In fact, if interstate holding companies are permitted to acquire FDIC-insured banks without becoming subject to the prudent restrictions on bank acquisitions and activities contained in the Act, then bank holding companies which are regulated under the Act would be placed at an increasing competitive disadvantage.

Conflicts of interest may arise when those who gather and redistribute capital are also allowed to take equity positions in other sectors of the economy. Both the separation of banking and commerce and our system of direct regulation, including transaction limitations and other consumer safeguards, such as anti-tie-in provisions and community reinvestment requirements, are designed to promote unbiased distribution of credit. It is clearly in the public interest to ensure that all sectors of the economy as well as all geographic areas are adequately and equitably served by financial intermediaries.

It is also clearly in the public interest to protect the franchise value of the bank charter. The value of a franchise bears a direct relationship to a market sector's tolerance for regulation. Congress must act to stem the tide of corporations which are not banks or bank holding companies, but which do own and operate banks or are otherwise offering bank-like services. If you do not, the franchise value of banking will be so dimin-

ished that no businessman in his right mind would put up with the level of public interest regulation imposed on banks. The erosion of the traditional private provinces of banking - of the uniqueness of banking - is far more serious than mere inter-industry squabbles.

Your alternatives to protection of the franchise value are (1) rapid, virtually uncontained expansion of bank powers in order that banks can remain competitive, destroying the uniqueness of banking, and (2) the removal of public interest regulations unique to banking. CSBS does not believe either alternative to be particularly wise, although we support some expansion of bank powers consistent with the principles of safety and soundness and we would be happy to participate with you in removing inefficient, wasteful and burdensome regulatory activity mandated by statutory excesses. CSBS believes that the franchise value of the bank charter should be protected and enhanced.

Clearly, there are the overriding public interest concerns which underlie our system of bank and bank holding company regulation. Unless the expansion of non-bank banks is halted, there can be little doubt that the fundamental policies embodied in the Act will be severely eroded or destroyed. If our Congressionally-designed system of bank regulation is in the public interest, then its circumvention stands alone as a public harm. The public interest is best promoted by avoiding nationwide disruption of our system of bank structure and regulation. Nationwide systemic harm, in itself, should be sufficient to compel Congress to intervene at this point. If it is to be determined that the current system is no longer valid, that it no

longer serves the public interest, that is for Congress to determine, not regulatory agencies and courts. Allowing others to decide by doing nothing is not an appropriate response. Nor is "let the market place decide" an appropriate response, where, as here, public interest considerations more far reaching than mere short-run competition and convenience enhancement are at stake.

Indeed, the Federal Reserve Board, in its Notice of Revision of Regulation Y (January 5, 1984), has appropriately pointed out that the growth of non-bank banks outside the statutory safeguards of the Bank Holding Company Act "threatens to undermine the system of bank holding company regulation as a whole." Similarly, in its order approving establishment of a non-bank bank in Florida by the U.S. Trust Corporation, the Board called for Congressional action to avoid widespread systemic harm:

If the nonbank bank concept, particularly as expanded by the interpretation of demand deposit adopted by the Tenth Circuit, becomes broadly generalized, a bank holding company or commercial or industrial company, through exploitation of an unintended loophole, could operate "banks" that offer NOW accounts and make commercial loans in every state, thus defeating Congressional policies on commingling of banking and commerce, conflicts of interest, concentration of resources and excessive risk, or with respect to limitations on interstate banking. Congressional action thus is urgently needed to ensure that the policies of the Act are maintained. In this regard, the Board does not believe that any public policy would be served by grandfathering proposals such as this that occur subsequent to the introduction of legislation that would otherwise prohibit such transactions. (Emphasis supplied)

Clearly, unless the proliferation of non-bank banks is halted it threatens to undermine the entire framework of regulatory policies which you, the Congress, have erected.

It is said that a man can never cross the same river twice, because each time both the man has changed and the river has changed. It is appropriate to examine, in brief, some developments which have occurred in which CSBS has been involved since the last time this Committee moved to close the non-bank bank loophole.

The IBAA and several Florida banks brought suit against the Comptroller of the Currency, alleging that the Comptroller's granting of "limited-purpose" national bank charters for "nonbank banks" violates the National Bank Act. IBAA v Conover (U.S. District Court for the Middle District of Florida). On February 15, 1985, the United States District Court for the Middle District of Florida granted plaintiffs' motion for a preliminary injunction and barred the Comptroller from granting final charter approvals for any more non-bank banks, pending the Court's final decision in this case.

On March 5, 1985, the Comptroller filed a motion requesting the District Court to modify its injunction so that it would not apply to (i) nonbank national banks which were acquired by bank holding companies pursuant to the approval of the Federal Reserve Board, and (ii) applications to charter nonbank national banks in areas other than Jacksonville. CSBS filed a brief as amicus curiae in support of the plaintiffs, arguing that the District Court's injunction should not be modified and should continue to have nationwide effect. On April 8, the Court denied the Comptroller's motion.

In a related action, on March 15, 1985, the Federal Reserve Board announced that it was suspending further processing of all

pending applications by bank holding companies to acquire nonbank national banks, based upon the District Court's injunction.

A case was brought by the Florida Department of Banking and Finance, the Florida Bankers Association and CSBS to challenge the validity of the Federal Reserve Board's U.S. Trust Corporation decision. Florida Department of Banking and Finance v. Board of Governors of Federal Reserve System. (U.S. Court of Appeals for the 11th Circuit) In that decision, the Board permitted U.S. Trust, a New York bank holding company, to establish a deposit-taking "nonbank" national bank in Florida without Florida's approval and in the face of a Florida statute which expressly prohibited such establishment.

CSBS and the Florida parties have argued that the Board's decision violates the Douglas Amendment by allowing an out-of-state bank holding company to acquire a deposit-taking Florida bank without Florida's authorization. It is also contended that the Board could not disregard the Florida statute which prohibited such acquisition and that the Board failed to weigh properly the public interest considerations set forth in the Act. The United States Court of Appeals for the Eleventh Circuit heard oral argument in this case on January 9, 1985. A decision in this case is expected in the near future.

On February 6, 1985, representatives of CSBS and the States of Florida and North Carolina testified at an informal hearing held by General Counsel Michael Bradfield of the Federal Reserve Board and his staff, concerning state laws which prohibit the acquisition of non-bank banks by all in-state and out-of-state bank holding companies and other holding companies. CSBS

testified that such state laws -- including those passed by Florida and North Carolina -- are constitutional and binding upon the Board under Section 7 of the Bank Holding Company Act.

As stated above, on March 15, 1985, the Federal Reserve Board declared that it was suspending further processing of applications by bank holding companies to acquire non-bank banks. The Board also returned to Citicorp its application to acquire a "nonbank" industrial bank in North Carolina. The Board stated that it could not act on the application until the North Carolina Supreme Court decided a pending appeal by Citicorp, in which Citicorp has challenged the decision of the North Carolina Commissioner of Banks disapproving Citicorp's acquisition as contrary to North Carolina's statute.

Several states have acted to close the non-bank bank loophole through state statutes which contain a definition of "banks" which differs from that found in the Act and/or contain a prohibition on non-bank bank ownership as an inappropriate non-banking activity for BHCs and other companies. The states are doing what they can in this area. However, we feel strongly that it is most appropriate that Congress act to resolve the non-bank bank problem once and for all.

Mr. Chairman, CSBS believes that enactment of a loophole closing bill is clearly in the public interest and will support you in your efforts to enact such legislation, as we supported your efforts in passing of S. 2851 in the last Congress. There is a need for an immediate restatement of Congressional policy in the area of non-bank banks.

STATE AUTHORITY UNDER THE DOUGLAS AMENDMENT

The Conference strongly supports clarification of the scope of state authority to permit interstate bank ownership by bank holding companies, as was contained in S. 2851.

Section 903 of that bill amends the Douglas Amendment to the Bank Holding Company Act and provides, inter alia:

"For the purposes of this section, a State may authorize a bank holding company, the banking operations of which are principally conducted in another State, to acquire, directly or indirectly, voting shares of, interest in, or all or substantially all of the assets of a bank located in such State. In determining whether and to what extent to permit such an acquisition by such a bank holding company, a State may allow such acquisition (1) without restriction, or (2) on the basis of the location of the States involved, the existence of laws providing for the reciprocal treatment of bank holding companies located in its State, or other similar conditions."

Mr. Chairman, in your colloquy on the Senate floor with Senator Tsongas, you made it clear that Section 903 was intended (1) to encompass interstate transactions already approved by the Federal Reserve Board under existing state law, (2) to uphold state authority to establish regional or other limitations imposed by state statute, (3) to clarify the powers that the states have always retained under the Douglas Amendment, including limiting interstate bank ownership to limited purpose banks, (4) to authorize state imposition of procedural and administrative requirements with regard to interstate acquisition of their banks, (5) to affirm the decision of the United States Court of Appeals for the Second Circuit in the Northeast Bancorp case, (6) to encompass limitations like those already passed by states such as Florida and North Carolina, and (7) to encompass "defensive"

reciprocity provisions (Congressional Record, September 13, 1984, at S11153). Unfortunately, the House of Representatives was unable to reach a consensus on matters contained in S. 2851 and took no action on that measure.

I would reiterate that the Conference strongly supports clarification of state authority as contained in S. 2851. However, nothing in my presentation today should be construed as expressing a value judgment on the desirability of any specific state legislative proposals, pending or yet to be introduced before the state legislature of any state. The Conference does not take a position for or against state laws to permit interstate ownership of banking facilities. CSBS does not attempt to dictate to individual states what should be done, nor does it attempt to bring uniformity to state statutes. Rather, the Conference exists to defend the right of states to determine their own financial institution structure, and to assist states in accomplishing their individual goals without risk of unintended side-effects or interference with the rights of sister states.

The Conference strongly opposes the preemption of state authority to determine bank structure, reserved to the states by Congress in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act. We oppose such preemption notwithstanding that it may be done in steps, or that it may be "triggered" by some state action, or that it may have a time delay. States have responded to the evolution of the banking system in a manner consistent with the intent of Congress in delegating authority over structure to them.

In my testimony today, I would like to stress the following

points:

- . concern over concentration of economic power formed the basis for the historical development of the state role and the policy determinations which underlie Congressional delegations of authority to the states,

- . decentralized control over structure continues to be in the public interest and states have acted consistently with the intent underlying the delegation of authority to them, and

- . the current system of decentralized control over structure, bolstered by a clarification of the scope of the delegation of authority to the states by Congress, continues to serve the public interest.

Background: A Brief History of State Authority Over Structure

Throughout the history of our uniquely decentralized system of banking and bank deregulation has run a consistent theme, that the undue concentration of economic power is a serious threat to our national common good and that decentralization of control over financial resources is the best means of ensuring against undue concentration of economic resources. It has been recognized that decentralized control serves the public interest in the long-term promotion of competition, in the avoidance of conflicts of interest and in ensuring that all sectors of the economy as well as all geographic areas are adequately and equitably served by financial intermediaries. It may be safely argued that all of these public interests and the potential for their abuse bear a relationship to the degree of control which can be exercised over the intermediation function. Aggregate concentration of finan-

cial resources in particular is to be shunned, since the role of money as the medium of exchange for all commodities carries with it inordinate power.

In 1832, President Andrew Jackson vetoed the rechartering of the Second Bank of the United States. Jackson and his supporters viewed the Second Bank as a dangerous center of concentrated financial power which threatened political and social democracy. Of concern was the Second Bank's exclusive control over the nation's currency and, thereby, the effective allocation of credit resources. Following the expiration of the Second Bank's charter in 1836, the federal government did not again enter the bank chartering field until the Civil War.

In the late 1830's, the "free banking" movement began at the state level. By allowing state banks to be chartered under general rules of incorporation, rather than requiring special acts of the legislature, a major step was taken toward our modern, highly competitive system of banking. Yet, such laws were designed to balance between encouraging the growth of banking and preventing the concentration of banking power. During this period, states were the exclusive chartering and regulatory authorities for banks.

In 1863, responding to problems encountered in financing the war effort, Congress enacted the National Currency Act--later replaced by the National Bank Act of 1864--to authorize a system of federally-chartered, but privately-owned national banks which would issue a new national paper currency. National banks were given no express branching authority under the National Bank Act and were held by the Supreme Court to be subject to state laws

restricting or prohibiting branching by state banks.

In response to the competitive inequality faced by national banks with respect to branching, Congress adopted the McFadden Act of 1927, which authorized national banks to establish branches within the municipality where their main banking facilities were located. However, the McFadden Act provided that national banks could establish such branches only if permitted by state law. Subsequent attempts to amend the McFadden Act to allow national banks to branch regardless of state law were met with stiff opposition on the ground that such an amendment would deprive the states of their control over banking structure and would result in a greater concentration of banking resources. Instead, Section 23 of the Banking Act of 1933 was adopted, which allowed national banks to establish branches only within their home state and only to the extent that state laws permitted branch banking. State control over bank structure was thus firmly established as the premier safeguard against undue concentration of banking resources.

In the early 1950's, supporters of the decentralized dual banking system became concerned with the growth of multi-bank holding companies, which were evading state branching laws by creating numerous subsidiary banks, both within and across state lines, and operating such banks essentially as branches. In addition, there was deep concern over moving too quickly and too far in the areas of permissible bank holding company activities and corporate ownership of financial institutions.

The Bank Holding Company Act of 1956 was enacted to accomplish two primary objectives: "it was designed to prevent the

concentration of banking resources in the hands of a few financial giants", and "it was intended to implement a Congressional policy against control of banking and nonbanking enterprises by a single business entity." As the U.S. Supreme Court recently noted, "underlying both objectives was a desire to prevent anticompetitive tendencies in national credit markets."

The Douglas Amendment to the Bank Holding Company Act, enacted as Section 3(d) of the Bank Holding Company Act of 1956, sought to further these ends by ensuring that national banks would not use bank holding companies as mechanisms to evade state-law restrictions on bank location. It represented a compromise between proponents of bank and bank holding company expansion interstate and those who opposed such expansion. It established a general federal prohibition against interstate acquisitions, but also allowed individual states to lift that prohibition by an explicit and specific statutory authorization to the contrary.

Senator Douglas declared that his amendment would carry out the long-established federal policy against the undue concentration of financial resources, in order to ensure both political liberty and economic competition:

...what the sponsors of the amendment are seeking to do is to prevent an undue concentration of banking and financial power, and instead to keep the private control of credit diffused as much as possible.

.

Andrew Jackson realized all this when he faced Nicholas Biddle and the Second Bank of the United States....[Jackson] wanted credit and banking to be decentralized and diffused so that men might be free.

Senator Douglas pointed out that in nations where banking resources had become concentrated in a few giant banks competition had diminished and industry had become concentrated. Therefore, he argued, the Act and his amendment were needed to "check and, if possible, to roll back the concentration of banking and credit" in the United States.

Senator Douglas also emphasized that his amendment would prevent bank holding companies from evading state limitations on bank expansion:

[O]ur amendment aims...to carry over into the field of holding companies the same provisions which already apply for branch banking under the McFadden Act--namely, our amendment will permit out-of-State holding companies to acquire banks in other States only to the degree that State laws expressly permit them; and that is the provision of the McFadden Act.

Historically, Congress has considered decentralization of control over financial resources to be the best means of ensuring against undue concentration of economic resources, of promoting competition, of avoiding conflicts of interest and of ensuring that all geographic areas are adequately and equitably served by financial intermediaries.

State Actions Are Consistent With Congressional Intent

As a compromise measure, the prohibition on the interstate ownership of bank subsidiaries by bank holding companies was not designed to be absolute--a lock without a key. It was designed to be a safe repository for the concerns of Congress about undue concentration of control over financial resources and anti-competitive market tendencies. The keys to that lock are entrusted to the states. The states are to determine if changes in

economic circumstances have altered the balance of public interest so as to warrant relaxation of that prohibition, and to what degree. The importance of the role entrusted to the states, watchdog over a key public interest determination, required a sweeping grant of authority. This is what was given in the Douglas Amendment. The maintenance of state control over bank structure remains our nation's greatest safeguard against undue concentration of economic power.

A significant number of state legislatures have taken up the question of how to respond to a changing marketplace and whether change in bank structure is warranted. In the context of the public interest considerations involved, it is appropriate that the states have reacted with approaches which vary widely. Some states have lowered barriers to interstate bank ownership with state laws passed pursuant to the authority under the Douglas Amendment. Others have elected to defer action, awaiting resolution of the legal issues now pending before the Supreme Court or allowing time in which to observe the effect of such structural changes in the lead states. The majority have either specifically rejected interstate proposals or have not had serious proposals before their state legislatures.

Basically, the statutes of those states which have acted to permit interstate bank acquisitions by bank holding companies fall into four general categories: non-reciprocal interstate laws (Alaska/Maine, reciprocal interstate laws (New York/Massachusetts/Connecticut/Rhode Island/Florida/Georgia/North Carolina/South Carolina/Virginia/Kentucky/Utah), limited-purpose charter laws (Delaware/South Dakota/Nebraska/Nevada/Maryland)

and emergency acquisition laws (Oregon/Utah/Virginia/Washington/et al).

I have appended to my written testimony a list of state statutes, grouped by limiting factors, which includes a brief description of each of those state laws falling in the first three categories.

You will note that these statutes are characterized by grouping them according to their common limiting factors or conditions. It is important to note that every state that has acted to specifically permit interstate bank acquisition has limited or conditioned that authorization in some manner. It seems appropriate, at this point, to discuss some of the reasons why states have elected to exercise their authority under the Douglas Amendment. No value judgment is herein made as to whether these reasons are valid or the state statutes will serve the purpose for which they were intended.

Many states have acted for economic development reasons. This can be in order to attract new investment capital or stem the outflow of domestic investment capital to other states, as exemplified by Maine's "net new funds" approach; it can be to create employment opportunities in a depressed economy, as exemplified by the South Dakota approach, or it can be a part of an overall corporate strategy, as exemplified by the Delaware approach.

Several states, including those with failing bank interstate legislation and some who have opted for broader interstate legislation, were motivated by a need to expand their list of alternatives in the handling of problem institutions. This may

be necessary because there are an insufficient number of qualified intrastate bidders, because the industry is already heavily concentrated, or because the premium which might be offered for an interstate foothold could far exceed the actual value of the failing institution.

Much of the current flurry of state legislative activity appears to be motivated by anti-concentration concerns and industry positioning strategies. This can be in the form of attempting to attain regional consolidation and strengthening before facing nationwide competition or to increase the pool of potential buyers and the price for individual institutions. Interestingly, the Maine experience suggests that acquisitions occur from the top down in terms of size and quality of institution rather than from the bottom up. This effect may cause disappointment among stockholders in some smaller institutions and those in public service sectors who sought to strengthen weak institutions with capital infusions.

One reason put forward by proponents of interstate legislation which appears to have little basis in fact is that the quantity and quality of financial services to a state's population will be greatly enhanced. There appears to be little relationship between the interstate ownership of financial institutions and the provision of adequate financial services on either an intrastate or interstate basis. First, it is difficult to identify a sector of the business community or the population which is not now adequately served. A great range of interstate services is available and, with the advent of new technology, these will increase. Deposit gathering is the only heavily

restricted interstate transaction which appears to bear a direct relationship with interstate ownership. Second, even if an inadequately served sector were identified, it is hard to imagine how interstate ownership would, of itself, solve such a problem. Specific remedial legislation would probably best serve to target funds or services to the sector which needs them.

In order to appropriately weigh the potential benefits of interstate banking, some offset for potential costs is necessary. These include potential net outflow of capital, potential loss of deposit-base expansion incentives, potential destruction of state-federal checks and balances, and potential for concentration of ownership and control of financial resources, with concomitant concentration of the economic power base. The degree of relevance of each of these potential costs and benefits to the economy and people of an individual state is a question which each state must assess. Some mitigation of potential costs or harms is, of course, possible through the use of statutory conditions or limitations on interstate operations.

It is absolutely necessary that states have the ability to place conditions and limitations on authorizations for interstate bank acquisitions. Without this capability, they cannot provide the effective safeguards which Congress intended. It is not economic protectionism about which we are speaking, but protection of the public interest.

The conditions and limitations which states have imposed are based on the same public interest considerations which caused Congress to create a decentralized banking system. As I stated before, concern with the undue concentration of economic resourc-

es is the linchpin, with additional public benefits accruing with the long-term promotion of competition, the avoidance of conflicts of interest and the guarantee that all sectors of the economy and all geographic areas are adequately and equitably served by financial intermediaries, including guarantees of local reinvestment.

The form of limitation most often attacked is the regional interstate approach. Virginia is one of the states which has adopted such an approach and I would like to clarify a few things about our statute.

First, we did not enter into a compact with any other state in our region. We did not sit our heads of state down and hammer out a treaty signed by the Governors and taken to our legislatures for ratification. All of the statutes were enacted independently by the respective state legislatures. Our statutes do not embody a formal agreement between states or create new powers exercised separate and beyond those of each enacting state. Similarities in terms within those statutes, resulting from some coordination between state bankers associations and state banking departments, resulted from attempts to draft better legislation and carry out the public interest purposes of the Acts. Such attempts constitute attempts to carry out Congressional intent, not to defeat it.

Second, our statute is not designed to bring about "balkanization" of our financial system for any discriminatory purpose or any other insidious purpose. The restrictions which were put in the statute were for valid public interest reasons, serving valid state and national interests in keeping with the purposes for

which the delegation was originally made.

The total bank assets of all Virginia banks combined are about \$37.6 billion. Their total deposits are about \$30.7 billion. The largest bank in Virginia has assets of about \$8.1 billion and about \$5.6 billion in deposits. The total bank assets of all New York banks, for example, are about \$633.6 billion. Their total deposits are about \$465 billion. Citicorp has assets of about \$120 billion and about \$27 billion in domestic deposits and about \$78 billion in total deposits. There are a dozen New York banks larger, by asset size, than the largest Virginia bank, nine of that dozen are more than twice as large.

It is clear to see that the "top-down" acquisition phenomenon which occurred in Maine could equally occur in Georgia. We fail to see the net public benefit in such a pattern. The banking systems of our sister states of North and South Carolina, Georgia and Florida more closely approximate our own. There will be some consolidation of banks and bank holding companies. But we fully expect that it will be of a type which enhances competition without resulting in undue concentration of resources. There is plenty of competition among small financial institutions such as community banks, savings and loans and credit unions. However, the top end of the banking spectrum tends to be dominated by a few large money-center banks. Allowing some consolidation and growth among medium-sized, regional banks and bank holding companies will tend to increase competition at the top. Top-down acquisitions, on the other hand, tend to decrease competition at the top.

Bank holding companies entering our state must get our approval, at which time we consider the effects of the proposed acquisition, including whether there will be a concentration effect, whether competition will, in fact, be promoted, whether there is potential for conflicts of interest, and whether there is a commitment to local reinvestment on the part of the applicant. We have the authority to impose conditions on approvals to ensure that these public interests are accommodated. We also have some teeth in enforcement, since each out-of-state bank holding company must subject itself to all of our laws, including our Virginia bank holding company statute.

It is clear to me that states which enact laws with such conditions do so in the public interest and for the purposes which Congress intended. It is equally clear to me that states must have the authority to impose such conditions if they are to effectively serve as the safe repository of public interest concerns. I am unsympathetic when the wolf yells "foul" as we lock the door to the chicken coop.

The Need For Congressional Clarification

Proponents of full interstate banking have argued that the Douglas Amendment was intended to be nothing more than an "on-off" switch, that states have no right to place conditions or restrictions on entry. This is totally out of keeping with the history of the Douglas Amendment. Moreover, the purposes underlying enactment of Douglas could not be served if that were true.

Legal questions as to the scope of state authority under the

Douglas Amendment are currently before the Supreme Court. All of those questions really revolve around public interest considerations. All of those questions, except the question of whether such laws are compacts, revolve around interpretations of the intent of Congress in resolving those public interest issues. All of those "legal" questions are in reality "policy" questions. "Policy" questions are most properly resolved by Congress.

It is appropriate that Congress reassert its will. The Senate did so last year in passing S. 2851, the Financial Services Competitive Equity Act, on September 13, 1984 by a vote of 89 to 5.

We strongly supported S. 2851. We hope that both houses of Congress will enact legislation which includes clarification of state authority in this session, preferably this year. It is of note that the specific authorizations contained in S. 2851 would sunset after five years. At that time Congress could act to extend its provisions, to halt further interstate bank acquisition, or to move to Congressionally-mandated interstate banking of one of several types. What is important is that this approach reserves the decision to Congress at a future date.

CSBS absolutely opposes any automatic "trigger" to full nationwide banking, whether aimed at all states or at only those which enact regional reciprocal statutes. There are critical public interests involved in abandoning our decentralized system of banking and such a decision should not be made "automatic" just because it is politically expedient to do so at this point in time. Full interstate banking is not "inevitable" unless Congress mandates that it be. Full interstate may well be the

eventual outcome, but why sign off on it now, effective at some future date, without a weighing of the public costs and benefits at that point in time in the future? It seems logical to wait and see what happens in states that have opened their borders. It seems appropriate to act on fact rather than on supposition. It seems only right that Congress reserve such a momentous decision to itself--yourselves.

One of the great strengths of the dual banking system is experimentation. States can act as laboratories for new ideas without putting the whole nationwide system and the public interests underlying it in jeopardy. Here you have a wonderful opportunity. As I have noted, the approaches taken by states vary widely. You have control states and several variables to observe. Experience may teach us that interstate operations always leads to concentration and decreased competition or it may teach us that such is simply not the case. We may find that some safeguards or conditions are totally ineffective, while others work beyond our wildest expectations. If you reserve the right to decide, you can throw out the bad and keep the good. You may opt for no interstate, for regional interest, for full interstate or, hopefully, for continuation of a decentralized system in which each state decides for itself. You may allow certain state-imposed conditions, while disallowing others.

State action serves your purposes in fashioning an industry which serves the public benefit and it is to your benefit to wait and watch. We are involved in a big step and I would hate to see you sell your house in your home state before the results are in.

In summation, the reasons for which a decentralized system of banking regulation was devised by you, the Congress, remain valid today. Undue concentration of economic power is a serious threat to our national common good. Decentralization of control over financial resources is the best means of ensuring against undue concentration of economic resources, of promoting competition, of avoiding conflicts of interest and of ensuring that all sectors of the economy and all geographic areas are adequately and equitably served by financial intermediaries.

Every state that has acted to specifically permit interstate bank acquisitions has limited or conditioned that authorization in some manner. The conditions and limitations which states have imposed are based on the same public interest considerations which caused Congress to create a decentralized banking system. It is absolutely necessary that states have the ability to place conditions and limitations on their authorizations, in order to provide the effective safeguards which Congress intended. States are acting in the public interest. Legislation designed to clarify the authority of states would be helpful, while legislation which included an "automatic trigger" is not in the public interest.

STATE AUTHORITY OVER STATE-CHARTERED BANKS

CSBS opposes broad preemption of state authority over the powers of state-chartered nonmember banks. During your consideration of S. 2851, you were faced with a decision as to whether to preserve or to preempt state authority over state-chartered banks. As introduced, S. 2851 dealt fairly with states, limiting their ability to export powers beyond those of bank holding

companies. As amended in Committee, it constituted an unprecedented and unjustified preemption of the authority of states to regulate within their own borders. CSBS strongly opposes this incursion into state authority under the dual banking system at the behest of an industry which has for years benefited from the reservation of authority to states under the McCarran-Ferguson Act.

Section 104(d) of S. 2851 was added by amendment by Senator Dodd of Connecticut in the Banking Committee on a 10 to 8 vote. Basically, the Dodd Amendment preempts the authority of a state to authorize its state-chartered institutions which are subsidiaries of bank holding companies to engage in insurance activities beyond those authorized for the parent holding company by the Garn-St Germain Act of 1982. This constitutes an unwarranted overreaction to a single bank holding company's unsuccessful attempt to use state law for the interstate export of a state bank's insurance activities. The Dodd Amendment would have serious adverse impact on many state-chartered institutions operating under existing state statutes.

State Authority Under The Bank Holding Company Act

In order to fully appreciate the harm caused by the Dodd Amendment, an understanding of the balance between state and federal authority pertaining to both the non-bank subsidiaries (Section 4) and the bank subsidiaries (Section 3) of a bank holding company under the Bank Holding Company Act is essential.

Section 3 subsidiaries are bank subsidiaries, chartered and operated as specialized institutions whose powers are determined by state banking codes or the National Bank Act for state-char-

tered and national banks, respectively. Limited in function, banks are generally limited in geographic scope of operations as well. That is, the McFadden Act and its application to both bank branches and other bank activities which display characteristics of bank branch activities have tended to cause those activities to be carried out within a state. Interstate activity by a bank itself has tended to be the exception, (e.g., loan production offices,) and has been viewed as such by the courts.

Section 4 (non-bank) subsidiaries are by their corporate nature available for interstate activity. Once incorporated, their activities follow the industry pattern of their non-BHC-owned competitors. Personal loan companies and mortgage finance companies may follow local laws and regulations within the states in which they operate, but they typically operate in more than one state.

A clear scheme of authorization and regulation is evident, distinguishing between deposit-taking banks and other corporations, the stock of which is held by the holding company. This Congressionally designed system is both logical and consistent with the concept of a dual banking system. States are basically free to permit state-chartered institutions to serve the public in ways consistent with the needs of each individual state, limited naturally by the controls on location with which banks must comply, which is also administered by the state. Interstate general corporate activities of holding companies, on the other hand, are controlled by the Congress and the Federal Reserve Board, both as type of activity and location.

The Garn-St Germain Act And The Citicorp Application

Congress, in Title VI of the Garn-St Germain Depository Institutions Act of 1982, determined that bank holding companies should be limited in establishing non-banking corporate subsidiaries to engage in the underwriting and sale of insurance products. Several of the exceptions to this general rule are of a geographically limiting nature. They include: credit-related insurance made where the bank holding company has an office and has made a personal loan, and insurance activity in towns so small as to induce only an already-present bank holding company to sell insurance there. In the grandfathering provisions, insurance activities are allowed in the state in which the bank holding company has its principal place of business, or in neighboring states or where it has already sold insurance prior to the grandfathering date. Finally, small bank holding companies, under \$50 million in total assets, were exempted; such bank holding companies are likely to be locally-oriented and not engaged in extensive out-of-state adventures.

Limitations on interstate corporate operations of BHC non-bank subsidiaries did not preempt state authority over state-chartered nonmember banks, both because of the limited nature of such activities and because to do so would have been out of step with the historical development of the dual banking system. In many states banks have long engaged in such activities under state law as a bank function; i.e., as part of the intrastate activities normally carried out in a bank or in its branches. Thus, the Garn-St Germain Act preserved the status quo as to state authority over its state-chartered institutions.

That balance, however, was to some degree upset by an application of Citicorp to establish a subsidiary of a state-chartered bank in South Dakota which would sell insurance nationwide, the provisions of the Garn-St Germain Act notwithstanding. This application was made pursuant to authority found in both the Federal Reserve Board's Regulation Y and the state statutes of South Dakota.

In 1971, the Federal Reserve Board amended its Regulation Y, which pertains to the activities of bank holding companies, to provide that a subsidiary of a bank might do anything which the parent bank might do. The purpose of this was to allow segregation of certain bank-related activities for management purposes.

In 1983, South Dakota enacted a law which permitted state banks to engage in insurance underwriting and brokerage activities. Such activities could be carried on on an interstate basis by a subsidiary of the bank pursuant to Regulation Y.

The continuing legislative controversy revolves about the proposed use of the South Dakota insurance law to enable an out-of-state bank holding company (Citicorp) to offer interstate insurance services which it would otherwise be precluded from engaging in. If a resolution to this situation is considered necessary, then it can be accomplished by attacking the novelty of the Citicorp proposal. Restoration of the balance between federal and state authority discussed above requires only that the "for export" (interstate) aspect of the South Dakota law be addressed, by limiting the interstate insurance activities of bank subsidiaries. Bank or corporate subsidiaries would then be allowed to provide insurance activities on an interstate basis,

only as constrained by Title VI of Garn-St Germain. This approach would be consistent with the scheme of bank and bank holding company regulation established to date.

S. 2851, as introduced, appropriately addressed the export situation by, as described in the accompanying Banking Committee Report, providing that,

"...a state bank subsidiary of a bank holding company may engage in activities outside the bank's home state only to the extent that such activities are permissible for bank holding companies under section 4(c)(8) of the BHC Act. This would permit state bank subsidiaries of bank holding companies to engage in a broader range of activities if permitted under state law, even if such activities may not be permissible for bank holding companies; provided those activities are limited to the authorizing state....The provision clarifies that such activities, if conducted outside of the authorizing state, are prohibited by the BHC Act. Thus, the home state activities of a state bank would be affected. Moreover, the provision would not limit state banks from engaging outside the authorizing state in the traditional deposit, lending, trust and similar activities of a bank, activities such as national banks may perform under the National Bank Act, and that would be 'banking' activities under section 4 of the Act. The limitation also would not affect any activities of a state bank which is not within a bank holding company system. This provision is not intended to limit the applicability of the non-banking provisions of the Act to bank holding companies and their subsidiaries or to otherwise affect the coverage of the Act."

The Conference of State Bank Supervisors, with the goal of avoiding broad preemption of state authority over the powers of state-chartered banks, has not opposed the approach originally taken in S. 2851.

The Dodd Amendment In Perspective

The Dodd Amendment to S. 2851, however, constituted an unwarranted preemption of state authority, which is anti-competi-

tive, anti-consumer and anti-state government. It would set a terrible precedent for federal interference with authority of states over their own institutions within their own borders.

CSBS strongly opposed the provisions of the Dodd Amendment and urged its deletion. Our position on this matter has not changed.

As described in the Banking Committee Report accompanying S. 2851, the Dodd Amendment added a provision to the bill "...which would specifically emphasize that all subsidiaries and affiliates of a bank holding company, including state bank subsidiaries and their affiliates, are subject to the insurance activities prohibitions and restrictions of Title VI of the Garn-St Germain Act." This clearly goes beyond the use of a bank subsidiary for interstate insurance activity by an out-of-state bank holding company.

The proposition that state-chartered banks affiliated with a holding company should be limited to the insurance activities permitted to corporate, non-banking subsidiaries of the holding company ignores the legislative history of the Bank Holding Company Act and precedents within the dual banking system.

The Senate Report accompanying the Bank Holding Company Act of 1956 (Senate Report No. 1095, July 25, 1955), made it clear that the dual banking system was to be preserved and extended into bank holding company regulation. It noted, "Considerable care has been taken to provide regulatory control over individual banks by Federal and State authorities. Yet there is at present only a very limited control over the activities of bank holding companies that manage or control banks." The history then

outlines a scheme of parallel authority over bank acquisition and operation in which the individual authority, the OCC or the State, retained its dominion over national or state-chartered banks, respectively. Yet, the bill treated regulation of the corporate side of bank holding companies differently, giving initial jurisdiction over the permissible corporate activities to the Federal Reserve Board, with a general reservation of power to the states, viewed primarily as "a right to be more restrictive regarding the formation or operation of bank holding companies within their respective borders than the Federal authorities can be or are under this bill." Referring to the reservation of powers clause (Section 7), the report states, "In the opinion of the committee, this provision adequately safeguards States' rights as to bank holding companies."

It is clear from the legislative history of the 1956 Act that individual authority of the OCC and the States were to be preserved as to their depository institutions, while the general thrust of the Act was to restrict interstate corporate activities of bank holding companies. This approach was continued in the 1970 amendment to the Act, in which a "more difficult standard" was adopted for non-banking activities to be approved by the Fed, but OCC and state authority over individual banks was left undisturbed.

In the 1970 debate over acceptable "closely related" (Section 4(c)(8)) bank holding company subsidiaries, Congress specifically retained the Federal Reserve, not bank regulators, as the agency which would give specific authorization for new, non-bank corporate activities of bank holding companies. The

Congress was able, through this decision, to fill the perceived gap between bank regulation adequately carried out by the OCC and state regulators and other activities carried out by corporate subsidiaries of companies which owned banks. Congress did not establish centralized Federal Reserve controls over national and state-chartered bank activities. Such a move, it was recognized, would have marked a radical departure from the dual banking system as opposed to the role of the Bank Holding Company Act as the controller of intercorporate affairs between banks and holding company-owned non-banking subsidiaries.

Congress has in recent legislation consistently chosen to keep the Federal Reserve out of the regulation of state-chartered nonmember banks. In the 1980 Monetary Control Act, Congress rejected mandatory Fed membership (and subsequent regulatory jurisdiction by the Fed) to solve the Federal Reserve's declining membership problem. In the International Banking Act, Congress determined that provisions of the Federal Reserve Act which are concerned with the Fed's supervisory authority should not be extended to nonmember depository institutions. In the Export Trading Company Act, the Congress eliminated proposed extension of Federal Reserve supervisory authority into areas already adequately covered by state law.

A consistent pattern of parallel regulation has been achieved. The Federal Reserve serves an important role in the Bank Holding Company Act as arbiter of those Section 4(c)(8) corporate activities closely related to banking. However, expansion of Federal Reserve Board regulatory authority over state nonmember banks has been consistently rejected. Such

extension would be inconsistent with the well-established view of Congress that the dual banking system already adequately assures effective supervision of state-chartered banks.

The proposition that state-chartered banks affiliated with a holding company should be limited to the insurance activities permitted to corporate, non-banking subsidiaries of the holding company ignores some basic facts about bank holding companies. As of December 31, 1982 there were 4,510 bank holding companies, the vast majority of which owned one bank and were organized in the holding company format for securities and tax law purposes. In other words, most one-bank holding company operations are not different than those of similar sized banks not in a holding company format. Thus, a limitation to the non-bank activities list would both unjustifiably affect thousands of institutions and create differences in powers for similar banks chartered under the same law.

The proposition that state-chartered banks affiliated with a holding company should be limited to the insurance activities permitted to corporate, non-banking subsidiaries of the holding company ignores the very real public benefits provided by our dual banking system, which would be undermined.

. States operate as laboratories for change. Many states have long permitted activities which are not in all respects identical to those of either national banks or non-bank subsidiaries permitted under the Bank Holding Company Act. The ability of states to charter banking corporations carries with it the duty to determine an appropriate scope of activities. Such responsibility has resulted in important public benefits, has led

to banks meeting local or specialized needs and has often resulted in subsequent action by Congress authorizing similar functions; e.g., bank branching in the 1920's and 1930's and NOW accounts in the 1970's. Indeed, one of the benefits of the dual banking system is that it motivates experimentation and innovation without putting the entire banking system at risk.

. State powers lead to local service and flexibility. Because current Congressional activity was occasioned by a state's insurance statute, it is appropriate to begin with an examination of insurance activities of state-chartered banks under state law. Local conditions have led many states to authorize state-chartered banks to meet local insurance needs. State law, regulations and interpretations promulgated thereunder, court decisions and longstanding tradition permit insurance brokerage--for at least credit-related insurance--in 29 states. Ten of these states allow some amount of general insurance brokerage as well. Six states, including South Dakota, allow some amount of insurance underwriting. It is clear that the longstanding exercise of this authority neither has occasioned the dire results opponents have asserted, nor has produced anything other than service within the granting states. Legislation prohibiting such activities within the authorizing states would be anti-competitive and an inappropriate remedy for the ills alleged.

. State authority over the powers of state-chartered institutions has added a healthy degree of flexibility to our banking system. It is difficult to believe that the significant loss of flexibility and service to local communities could be

justified in prohibiting activities which engender no safety and soundness risk.

The preemption of state authority in this area is not in the public interest; would cast too large a net, given the current controversy; would remove from the public services which had been offered without controversy until now; and would create unequal and unfair regulation based on organizational structure. The provisions of S. 2851, as introduced, were a more appropriate response to the continuing legislative controversy.

As discussed above, S. 2851 without the Dodd Amendment would have allowed state bank subsidiaries to engage in activities beyond those permissible on the 4(c)(8) laundry list only within their own borders. This addressed the "for export" nature of the Citicorp proposal and the South Dakota law. It retains state authority over state-chartered banks within its individual borders, but precludes use of those banks to avoid limitations on the interstate operation of non-banking subsidiaries of the bank holding companies.

CSBS believes that the approach contained in S. 2851, as introduced, was an acceptable and certainly more appropriate response to the question of state authority over the powers of state-chartered institutions.

STATUS OF ATMS UNDER STATE BRANCHING LAWS

The Conference supports the use of unmanned electronic funds transfer systems to deliver better customer services. Toward this end, on October 31, 1980, our Board of Directors adopted a policy of encouraging enactment of state statutes embodying the following.

1. States should encourage the establishment of unmanned electronic funds transfer (EFT) systems within the states by banks or others which, by contract or agreement, will enable customers of local financial institutions to obtain financial services when customers are away from their banks. This procedure will enable individual banks better to serve their customers and retain their customer bases.
2. States should encourage the establishment and operation of such EFT systems subject to reasonable requirements as the state may choose, including the nature and geographic scope of transactions to be offered.
3. States should supervise and examine state-chartered institutions providing EFT services for customers of institutions located elsewhere; and the Comptroller of the Currency or the Federal Home Loan Bank Board should supervise and examine respective federally chartered institutions.
4. Should an amendment to Section 36(c) of the National Bank Act (The McFadden Act) be found necessary to enable national banks to make use of the state statutes proposed herein, the Committee recommends that CSBS either support, or alternatively, agree to the necessary Congressional action.

In essence, we sought to encourage state exceptions to structural constraints, with such conditions, both operational and geographic, as each state saw fit. To the extent that an exception was created, we felt that it should apply to national banks as well as state banks, so long as the conditions on those exceptions applied as well.

Underlying these policies is a belief that a balance must be struck between public interest in the expansion of service provision and public interest in maintaining a competitive market by safeguarding the competitive equality of local institutions and by avoiding concentrations of power. This is true even when dealing with shared ATM systems which maximize efficiency from both a bank and bank customer standpoint. High up front costs and large-scale efficiencies in ATM systems renders shared ATM

systems both a mechanism to ensure local access and competitive equality and a mechanism susceptible to centralized control by a few large institutions. In the short term, competition for participants will guarantee access for smaller institutions and maximize user access. In the longer term, economies of scale may tend to concentrate and consolidate existing systems and limit entry of new competitors, absent safeguards such as now contemplated in many state statutes. Public interests in ATM location and function closely parallel public interest in bank branching as embodied in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

The relevant federal statutes are 12 U.S.C. §§36 and 81. Section 81 requires each national bank to conduct its "general business" at its main office, as stipulated in its organizational certificate, and at its "branch or branches, if any, established or maintained by it in accordance with the provisions of (12 U.S.C. §36)." Section 36(c) provides that a national bank may not "establish and operate new branches" except within the state in which the bank is located, and then only to the extent that state-chartered banks in that state are permitted to establish and operate branches. The term "branches" is defined in Section 36(f) as including "any branch bank, branch office, branch agency, additional office, or any branch place of business. . .at which deposits are received, or checks paid, or money lent."

The Supreme Court and three U.S. Courts of Appeal have pointed out that the scope of the term "branch" is not limited to offices which perform the three functions designated in Section 36(f) but also is intended by Congress to include any place at

which a bank transacts "any business carried on at the main office." In one of these cases, Colorado ex rel. State Banking Board v. First National Bank of Fort Collins, the Tenth Circuit Court of Appeals held that a national bank's off-premises customer-bank communications terminal (CBCT) was a "branch" not only because it permitted the bank to receive deposits, one of the activities expressly described in Section 36(f), but also because it permitted the bank's customers to perform other "traditional banking transactions," namely, the withdrawal of funds and the transfer of funds from one account to another. And, in IBAA v. Smith, the U.S. Court of Appeals for the District of Columbia Circuit held that credit card and loan payments made by means of CBCT's were banking transactions within the scope of Section 36(f) even if they could not be considered to be "deposits".

Relying upon the Supreme Court's analysis in Plant City, the Court held that considerations of "competitive equality" between state and federal banks, rather than private contractual relationships between a bank and its customers, determine whether a facility is a "branch". Because banks with CBCT's could provide banking services to their customers away from their offices and thereby obtain a competitive advantage over banks which did not have CBCT's, the Court held that CBCT's were "branches" under Section 36(f). The Court then set out the rule that state law applicable to CBCT's is a part of the branching laws of the state incorporated by the McFadden Act and made applicable to national banks:

The net result of the above analysis is as

follows: If a state permits its state-chartered banks to establish CBCT's for the purpose of (1) receiving deposits, or (2) paying checks, or (3) lending money, then national banks in that state also can establish CBCT's limited to the functions permitted under state law.

This result would hold true even in a state that prohibits branch banking, but permits the use of CBCT's since they are not considered "branches" under state law.

Since we hold that off-premises CBCT's are "branches" within the meaning and intent of section 36(f)'s federal definition, for each CBCT a national bank wishes to establish it must (1) file a branch application with the Comptroller, (2) secure the Comptroller's approval, and (3) satisfy the capital and surplus requirements for branches found in (a) sections 36(d) and 51 of the National Bank Act and (b) the state banking statutes. Our holding, however, does not mean that national banks can not establish and operate off-premises CBCT's in a state (e.g., Florida) that generally prohibits branch banking when that state does not define CBCT's as "branches" for purposes of state law. Under section 37(c) national banks can establish and operate CBCT's "...when, where, and how state law would authorize a state bank to establish and operate such a branch...":

A national banking association may, with the approval of the Comptroller of the Currency, establish and operate new branches (i.e., CBCT's)...if such establishment and operation are at the time authorized to State banks by the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to the restrictions as to location imposed by the law of the State on State banks.

Of course, in order to secure the Comptroller's approval, national banks will have to comply with any additional restrictions on CBCT's prescribed by the Comptroller, e.g., the thirty day notice requirement and the fifty mile limit. Under the federal statutory scheme CBCT's are "branches" within section 36(f)'s federal definition; therefore, for federal purposes the state law applicable to CBCT's is a part of the "branch" banking law of that state, which is incorporated into the National Bank Act by section 36(c). (footnotes omitted) IBAA v. Smith, 534 F2d 921,

948-949 (D.C. Circuit), cert. denied, 429 U.S. 862 (1976)

Under the McFadden Act, the question of whether a particular facility is a branch of a national bank is resolved solely by the application of the functional test of whether it is a place of business "at which deposits are received, or checks paid, or money lent." If any of those functions are performed, the Comptroller must follow state law in approving the branch, including state law applicable to ATMs or CBCTs.

However, the U.S. Court of Appeals for the Second Circuit was recently called upon to apply the principles embodied in the McFadden Act to shared ATM networks. That court held that "...a national bank's usage of a shared ATM which it does not own or rent, does not constitute the establishment and operation of a branch under Sections 36(c) and (f) of the McFadden Act. The Court emphasized the phrase "establish and operate" in Section 36(c) rather than the functional definition in Section 36(f). In essence, it found that although an ATM may be by definition a "branch" of a national bank, its usage did not constitute the "establishment and operation" of a branch under the Section which makes state law applicable and limits their interstate placement.

By giving deference to the arbitrary distinction between ATM's owned or rented by national banks and those simply used by national banks for banking transactions, the court ignored both the prohibition on interstate branching and the deference to State law which are fundamental to the McFadden Act. The court also ignored the earlier court's decision in IBAA v. Smith.

In addition, the Court reopened the question of whether a

third party ATM operator was doing an illegal banking business and remanded this question for resolution under state law. If a shared ATM is not a branch of the bank in question, the operator is acting as an agent for the bank in taking deposits. States can move, and some have moved, to prevent corporations other than banks or bank holding companies from taking deposits on behalf of banks. Also, if shared ATMs are, by definition, branches for purposes other than 36(c), the only section in which the "established" clause appears, all other provisions which pertain to branches still apply.

Congressman Thomas Ridge of Pennsylvania has introduced a bill on the House side, H.R. 2099, which, in his own words:

"I introduced H.R. 2099 which would reestablish the principles embodied in the McFadden Act, yet do so in such a way as to permit existing ATM networks to continue to operate. I feel that it is important for Congress not the courts, to strike the new balance and apply the public interest tests to emerging technologies such as ATMs. Briefly, the bill:

One, amends the McFadden Act to allow for national banks to branch on an interstate basis when the exporting State expressly authorizes out-of-State banks to establish interstate branches within its borders;

Two, restores the principle that State ATM laws are part of the branch banking laws of a State, made applicable to national banks by the McFadden Act;

Three, provides that shared ATM networks do not count toward capitalization of a bank; and

Four, provides a waiver procedure for the OCC to bypass the branch approval process for shared ATM networks.

H.R. 2099 is, in essence, a compromise measure, splitting the difference between competing constituencies and competing public interests. I would appreciate the support of each and every

member of the House interested in expanding services for the banking consumer."

In his floor statement accompanying introduction of that bill, Congressman Ridge made an eloquent argument for Congressional action:

"No matter what the final outcome of litigation, the public will be a net loser either short term or long term. No one would allege that the complete dismemberment of our current, extensive share ATM systems is in the public interest, although this could be the result if it is decided shared ATM's are branches for all purposes. On the other hand, if the recent circuit court decision is left intact, an entire body of State law is preempted and the congressional concern over concentration of economic resources, which underlies the decentralization of control over structure, will be undercut. Only Congress can restrike the balance between these valid, yet competing, public interests. The reinterpretation and reapplication of existing policies established by Congress is a role most properly reserved to Congress."

The Conference is supporting H.R. 2099 on the House side and we hope that a similar measure might be considered by this body. For this reason, I have attached those pages of the Congressional Record containing H.R. 2099 and the floor statement of Congressman Ridge to my testimony.

NEW BANK AND BANK HOLDING COMPANY POWERS

CSBS recognizes that some expansion of bank and bank holding company roles is necessary to meet market challenges. We have, as a body, adopted a policy which would endorse some expansion of banking powers, following a weighing of public interest considerations. A copy of that policy is attached hereto.

Our position, as bank regulators, places us somewhere between those who call for complete deregulation and open across-the-board competition--"financial supermarkets", if you

will--and those who would halt the flow of progress completely. We favored and actively worked for liability-side deregulation, both because it benefited the public and because it allowed banks to be competitive in attracting funds, adding thereby to the industry's long-term viability. As the 97th Congress was the time for liability-side deregulation, so now is the time for some asset-side deregulation. The reasons remain the same: to assure long-term viability of the industry, to give the public the benefits of increased competition, and to facilitate better allocation of financial resources.

However, there are some balances which must be struck. The ability to compete and assure long-term industry viability must be balanced against the potential for risk in each new activity and the public interest in safety and soundness. The avoidance of concentration of economic power in the hands of relatively unregulated business entities must be balanced against the risk of increased concentration of economic power within the banking industry itself. The benefits of relaxing distinctions between banking and other lines of commerce must be balanced against the potential for erosion of the unique role of banks in our payments system, as intermediaries between organizations and people and as safekeepers of deposits and savings not placed at risk.

The continued viability of banking as a mechanism as well as an industry demands a balanced approach to deregulation. The end result must be a healthy industry able to serve local community, as well as national and international, needs.

The Conference supports some expansion of bank powers. However, we oppose limiting new bank powers to the subsidiaries

of bank holding companies only, requiring conversion to the holding company format in order for a bank to benefit from deregulation. We favor allowing banks which are not already a subsidiary of a holding company to operate the new activities out of a separate subsidiary of the bank itself.

Basically there are two arguments put forth in favor of granting new powers to bank holding company subsidiaries only: (1) the increased safety and soundness of the "Chinese Wall" and (2) the regulatory savings and use of available expertise through regulation by function.

The members of the Conference have seen no evidence that the "Chinese Wall" restrictions contained in the Bank Holding Company Act provide an effective safety and soundness barrier to institutional failure. Rather, they are "fair weather" safeguards which are all too easily ignored when failure of a major holding company subsidiary is imminent. The failure of holding companies, brought about by the failure of non-bank subsidiaries, have not been able to be kept from impacting upon subsidiary banks. To the extent that any value does derive from transaction limitations between bank and non-bank subsidiaries, those same benefits could be derived from extending similar limitations to transactions between a bank and its subsidiary and from requiring separate capitalization.

The Conference endorses the concept of regulation by function with regard to many proposed new activities, including insurance and securities activities. The expertise of existing agencies should be fully utilized, the potential for duplicative and overlapping regulation and examination should be avoided and

the type and level of regulation should be equal for competitors engaging in the same activities. But, again, none of the benefits of regulation by function would be enjoyed less if applied to separate bank subsidiaries.

These considerations are especially true when applied to state and municipal revenue bond underwriting. CSBS has long advocated allowing banks to underwrite these bonds, based primarily upon the benefits which would accrue to state and local governments and to the public at large, with little or no increase in risk to banks. The case for this minor change in bank powers has been made on the record before this Committee many times. Several times adding municipal revenue bond underwriting authority to existing bank authority to underwrite general obligation bonds has come close to enactment. State and municipal revenue bond underwriting should be permitted to banks, as is the case with underwriting of general obligation bonds.

SUMMARY AND CONCLUSION

Closing the non-bank bank loophole remains our top priority, notwithstanding any changed circumstances since the last Congress.

Through the non-bank bank mechanism, the Bank Holding Company Act of 1956 is being used to achieve exactly what it was designed to prevent. As the United States Supreme Court recently set out, the Act was enacted to accomplish two primary objectives: "...it was designed to prevent the concentration of banking resources in the hands of a few financial giants...", and "...it was intended to implement a Congressional policy against control of banking and nonbanking enterprises by a single

business entity." As the Court noted, "...underlying both objectives was a desire to prevent anticompetitive tendencies in national credit markets."

The Bank Holding Company Act represents an effort to control the mixing of banking and commerce and to prevent undue concentrations of economic power. As such, it is a continuation of themes which are found throughout the history of bank regulation. The Act provides for measured deregulation of the banking industry in areas beyond traditional banking services. It was Congressional response both to the need for some service expansion and to the feeling that there was danger in moving too quickly or too far in the areas of permissible bank holding company activities and corporate ownership of financial institutions.

The section of the Act pertaining to non-banking activities of BHCs represented the trade-off between the two above-identified public interests. It delineates the standard for permissible non-banking activities and, thereby, limits the ownership of banks by corporations engaging in non-banking activities. The overriding public interest concerns were written right into the Act. These are:

- . public interest in a stable, risk-insulated banking system
 - safety and soundness;
- . public concern over the undue concentration of financial resources;
- . public benefit derived from the promotion of competition and the avoidance of longer-term anti-competitive tendencies in our credit markets; and

. public interest in avoidance of conflicts of interest, in the unbiased distribution of credit and other consumer safeguards.

Unless the expansion of non-bank banks is halted, there can be little doubt that the fundamental policies embodied in the Act will be severely eroded or destroyed. If our Congressionally-designed system of bank regulation is in the public interest, then its circumvention stands alone as a public harm. Nationwide systemic harm, in itself, should be sufficient to compel Congress to intervene at this point.

CSBS believes that enactment of a loophole closing bill is clearly in the public interest and will support you in your efforts to enact such legislation, as we supported your efforts in passing of S. 2851 in the last Congress. There is a need for an immediate restatement of Congressional policy in the area of non-bank banks.

The Conference strongly supports clarification of the scope of state authority to permit interstate bank ownership by bank holding companies, as was contained in S. 2851.

The Conference strongly opposes the preemption of state authority to determine bank structure, reserved to the states by Congress in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act. We oppose such preemption notwithstanding that it may be done in steps, or that it may be "triggered" by some state action, or that it may have a time delay. States have responded to the evolution of the banking system in a manner consistent with the intent of Congress in delegating authority over structure to them.

The reasons for which a decentralized system of banking regulation was devised remain valid today. Undue concentration of economic power is a serious threat to our national common good. Decentralization of control over financial resources is the best means of ensuring against undue concentration of economic resources, of promoting competition, of avoiding conflicts of interest and of ensuring that all sectors of the economy and all geographic areas are adequately and equitably served by financial intermediaries.

Every state that has acted to specifically permit interstate bank acquisitions has limited or conditioned that authorization in some manner. The conditions and limitations which states have imposed are based on the same public interest considerations which caused Congress to create a decentralized banking system. It is absolutely necessary that states have the ability to place conditions and limitations on their authorizations, in order to provide the effective safeguards which Congress intended. States are acting in the public interest. Legislation designed to clarify the authority of states would be helpful, while legislation which included an "automatic trigger" is not in the public interest.

One of the great strengths of the dual banking system is experimentation. States can act as laboratories for new ideas without putting the whole nationwide system and the public interests underlying it in jeopardy. Here you have a wonderful opportunity, since the approaches taken by states vary widely. You have control states and several variables to observe. If you reserve the right to decide at a point in the future, you can

throw out the bad and keep the good. You may opt for no interstate, for regional interest, for full interstate or, hopefully, for continuation of a decentralized system in which each state decides for itself.

CSBS opposes broad preemption of state authority over the powers of state-chartered nonmember banks. As introduced, S. 2851 dealt fairly with states, limiting their ability to export powers beyond those of bank holding companies. As amended in Committee, by Senator Dodd, it constituted an unprecedented and unjustified preemption of the authority of states to regulate within their own borders. CSBS strongly opposes this incursion into state authority under the dual banking system at the behest of an industry which has for years benefited from the reservation of authority to states under the McCarran-Ferguson Act.

The Conference supports the use of unmanned electronic funds transfer systems to deliver better customer services.

However, we believe that a balance must be struck between public interest in the expansion of service provision and public interest in safeguarding the competitive equality of local institutions and avoiding concentrations of power. Public interests in ATM location and function closely parallel public interest in bank branching as embodied in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

However, the U.S. Court of Appeals for the Second Circuit was recently called upon to apply the principles embodied in the McFadden Act to shared ATM networks. That court held that "...a national bank's usage of a shared ATM which it does not own or rent, does not constitute the establishment and operation of a

branch under Sections 36(c) and (f) of the McFadden Act. The Court emphasized the phrase "establish and operate" in Section 36(c) rather than the functional definition in Section 36(f). In essence, it found that although an ATM may be by definition a "branch" of a national bank, its usage did not constitute the "establishment and operation" of a branch under the Section which makes state law applicable and limits their interstate placement.

By giving deference to the arbitrary distinction between ATM's owned or rented by national banks and those simply used by national banks for banking transactions, the court ignored both the prohibition on interstate branching and the deference to State law which are fundamental to the McFadden Act. In so doing, the court upheld a regulation of the Comptroller of the Currency and ignored the earlier court decision that State law applicable to electronic banking devices is a part of the branch banking law of the State, made applicable to national banks by the McFadden Act.

The principles established in the McFadden Act must be reestablished with regard to ATMs. This must be done in such a way as to permit existing ATM networks to continue to operate. It is important that Congress--not the courts--strike a new balance and apply the public interest tests to emerging technologies such as ATMs.

Congressman Thomas Ridge has introduced a bill on the House side, H.R. 2099, to accomplish these ends. The Conference is supporting H.R. 2099 on the House side and we hope that a similar measure might be considered by this body. I have attached those pages of the Congressional Record containing H.R. 2099 and the

floor statement of Congressman Ridge to my testimony.

CSBS recognizes that some expansion of bank and bank holding company roles is necessary to meet market challenges. We have, as a body, adopted a policy which would endorse some expansion of banking powers, following a weighing of public interest considerations. A copy of that policy is attached hereto.

As the 97th Congress was the time for liability-side deregulation, so now is the time for some asset-side deregulation. The reasons remain the same: to assure long-term viability of the industry, to give the public the benefits of increased competition, and to facilitate better allocation of financial resources.

Thank you, Mr. Chairman and members of the Committee.

FORMS OF STATE STATUTES ALLOWING
INTERSTATE BANK OWNERSHIP BY BANK HOLDING COMPANIES

Non-Reciprocal Interstate

ALASKA (1982) Provides for interstate acquisitions, restricted to acquisition of existing banks and bank holding companies, with state approval required.

MAINE (1984) Provides for interstate acquisition of one or required; approval required that there be a finding by the state banking superintendent that "net new funds" will accrue to the state and that a written plan be submitted for meeting the credit needs of consumers and small businesses. (Prior to 1984 reciprocity was required.)

OREGON (1985) Provides for interstate acquisition of banks or bank holding companies in existence for three or more years, but limited to the states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Utah or Washington, and subject to state approval upon certain findings; conditions may be placed upon the approval of an applicator; and specific provision is made for regulation by the Superintendent of Banks.

ARIZONA (1985) Provides for nationwide interstate acquisition of banks or bank holding companies in existence for five or more years, subject to state approval; de novo entry is allowed beginning in 1992.

Reciprocal Interstate

NEW YORK (1982) Provides for interstate acquisition of one or more existing institutions to the extent that such acquisi-

tions are allowed in the acquiring institution's home state.

MASSACHUSETTS (1982), CONNECTICUT (1983) and RHODE ISLAND (1984) Provide for interstate acquisition of banks or bank holding companies to the extent that such acquisitions are allowed in the acquiring institution's home state, but limited to the six states in the New England region (Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont); reciprocity is extended nationwide by Rhode Island in July 1985.

FLORIDA (1984), GEORGIA (1984), NORTH CAROLINA (1984), SOUTH CAROLINA (1984) and VIRGINIA (1985) Provide for interstate acquisition of existing banks or bank holding companies to the extent that such acquisitions are allowed in the acquiring institution's home state, but limited to certain Southeastern states (Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia and D.C.) and subject to state approval; the Florida statute does not extend reciprocity to Kentucky and the Georgia statute does not extend reciprocity to Arkansas, Maryland, West Virginia or the District of Columbia; to qualify as a "Southern Region bank holding company", a BHC must have its principal place of business in a state within the region, must have 80% of its deposits in subsidiaries within the region, and must not be controlled by a non-Southern Region bank holding company; an out-of-state bank holding company must register as a foreign corporation and subject itself to laws of the host state; and if any part of a state statute is determined to be invalid or

unconstitutional, the statute is null and void with lawfully consummated transactions grandfathered.

KENTUCKY (1984) Provides for interstate acquisition of existing banks or bank holding companies to the extent that such acquisitions are allowed in the acquiring institution's home state, but limited to states contiguous to Kentucky, and subject to state approval upon certain findings by the Commissioner of Banking; nationwide reciprocal interstate acquisitions are allowed automatically two years from the date of enactment; and acquisitions are limited to three Kentucky banks per year for the first five years.

UTAH (1984) Provides for interstate acquisition of existing depository institutions and depository institution holding companies to the extent that such acquisitions are allowed in the acquiring institution's home state, but limited to the states of Alaska, Washington, Oregon, Idaho, Wyoming, Montana, Colorado, New Mexico, Arizona, Nevada and Hawaii, and subject to state approval upon certain findings; specific provision is made for examination and supervision of any out-of-state depository institution or depository institution holding company authorized to do business in Utah; and if the regional reciprocity limitation is held to be unconstitutional, the statute is a nullity and no interstate acquisitions are allowed.

INDIANA (1985) Provides for interstate acquisition of banks or bank holding companies in existence for five or more years to the extent that such acquisitions are allowed in the acquiring

institution's home state, but limited to the states of Illinois, Kentucky, Michigan and Ohio, and subject to state approval upon certain findings; limitations are imposed as to the portion of the state's deposit base that any bank may hold; and an "opt-out" would allow Indiana banks to request protection from unfriendly takeovers interstate or intrastate.

Limited Charter Legislation

DELAWARE (1981) and MARYLAND (1983) Permit an out-of-state bank holding company to open one new, single-office bank, with minimums of \$10 million in capital (\$25 after one year) and 100 employees; the bank must be located and operated as not to directly compete with existing institutions for their customer base; the Delaware bank provisions were part of a larger economic development package including tax incentives and credit card rate export provisions designed to attract corporations to Delaware.

SOUTH DAKOTA (1980, 1983) Permits an out-of-state bank holding company to open a new bank or acquire an existing bank, with \$5 million minimum capital, which banks may export credit card rates and insurance, but may not compete directly with South Dakota banks or insurance agents or brokers.

NEBRASKA (1983) Permits an out-of-state bank holding company to open one new single-office bank, with minimums of \$2.5 million in capital and 50 employees, limited to running a credit card operation and prohibited from competing with existing institutions for their customer base.

NEVADA (1984) Permits an out-of-state bank holding company to acquire an existing bank, with \$5 million minimum capital, provided that the acquired bank will not solicit commercial loans or individual loan or deposit accounts in Nevada, thereby limiting the operation to essentially credit card operations and non-banking activities.

April 18, 1985

CONGRESSIONAL RECORD — Extensions of Remarks

E 1593

H.R. 2099

HON. THOMAS J. RIDGE

OF PENNSYLVANIA

IN THE HOUSE OF REPRESENTATIVES

Thursday, April 18, 1985

● Mr. RIDGE. Mr. Speaker, yesterday I introduced H.R. 2099, the Automatic Teller Machine Competitive Equity Act of 1985. This legislation is designed to restore the principles embodied in the McFadden Act as applied to ATM systems. It is offered in an attempt to reestablish the applicability of the McFadden Act, which governs the branching of national banks, to automatic teller machines and other electronic devices at which banking functions are being performed.

The McFadden Act, enacted in 1927, sought to establish competitive equality between State and national banks by allowing national banks to branch to the same extent as State banks. A balance was struck between concerns over preventing the concentration of banking resources and the need to ensure the competitiveness of national banks. For the purposes of the National Bank Act, the McFadden Act defines a branch as a place of business "at which deposits are received, or checks paid, or money lent." (12 U.S.C. Sec. 36(f).) The question of whether a particular facility is a branch of a national bank under the McFadden Act is answered solely by the application of this functional test.

Once a particular facility has been determined to be a branch, location is determined by State law under section 36(c) of the act. That section both precludes interstate branching and establishes competitive equality by allowing national banks to "establish and operate" branches at locations "authorized to State banks by the statute law of the State in question." "subject to the restrictions as to location imposed by the law of the State on State banks." These provisions have been consistently held to require that the Comptroller must follow State law in approving branches of national banks, including limitations as to banking functions which may be performed at branches. For example, under the McFadden Act, an armored car service has been held to be a branch under the functional definition of the act,

making it illegal under Florida law which prohibited banks from having more than one place of business.

The question of whether an ATM, then called a customer bank communication terminal or CBCT, was a branch first arose about a decade ago. In 1976, the U.S. Court of Appeals for the District of Columbia Circuit held that CBCT's are branches within the meaning of the McFadden Act if "deposits are received, checks paid or money lent" at such machines and that the McFadden Act was intended to include virtually all off-premises banking operations. Therein, the court recognized that the reservation of the control of branching to the State was done in order to allow States to safeguard against large concentrations of power. The critical holding in that case was that, "Under the Federal statutory scheme CBCT's are 'branches' within section 36(f)'s Federal definition; therefore, for Federal purposes the State law applicable to CBCT's is a part of the 'branch' banking law of the State, which is incorporated into the National Bank Act by section 36(c)."

However, the U.S. Court of Appeals for the Second Circuit was recently called upon to apply the principles embodied in the McFadden Act to shared ATM networks. That court held that "... a national bank's usage of a shared ATM which it does not own or rent, does not constitute the establishment and operation of a branch under sections 36 (c) and (f) of the McFadden Act."

By giving deference to the arbitrary distinction between ATM's "owned or rented" by national banks and those simply "used" by national banks for banking transactions, the court ignored both the prohibition on interstate branching and the deference to State law which are fundamental to the McFadden Act. In so doing, the court upheld a regulation of the Comptroller of the Currency and ignored the earlier court decision that State law applicable to electronic banking devices "is a part of the 'branch' banking law of the State," made applicable to national banks by the McFadden Act. Although the court gave great deference to the interpretive regulation of the Comptroller, it noted that "Should Congress find itself in disagreement with the Comptroller's regulation, which we accept as a legitimate interpretation of the governing statutes, legislative solution is available."

A legislative solution is indeed available. I feel strongly that we must act to restore the principles of the McFadden Act in regard to ATMs. My reasons are as follows:

One, State control of structure as a safeguard against undue concentration of economic power is an important element of our banking system. The dual banking system is unique among world banking systems in that it ensures a great number of institutions of diverse

sizes and types. The system also guarantees access to capital in all geographic areas and in all sectors of the economy.

Two, there is a strong public interest in a system of bank supervision which balances the short-term enhancement of competition and the long-term avoidance of anticompetitive tendencies in national credit markets. Maintaining this balance is especially critical in the ATM area since establishment of systems is expensive and susceptible to domination by large institutions, whether as system operators, as franchise operators, or as preferred users on shared systems.

Three, a situation of competitive inequality has been created, in which national banks, through shared ATM's, may offer full banking services on a nationwide basis without regard for the pertinent State laws, including restrictions on the interstate taking of deposits. Rather than restoring competitive equality, as it seems to have intended, the circuit court merely shifted the competitive advantage to national banks. Competitive equality is best maintained by saving the shared ATM systems, but making all of the players subject to the same rules.

Four, the issues involved in the decision are certain to be litigated further, both on appeal to the Supreme Court and on a remanded issue of whether corporations which nominally own an ATM are conducting an illegal banking business on behalf of bank participants in the system. No matter what the final outcome of litigation, the public will be a net loser either short term or long term. No one would allege that the complete dismemberment of our current, extensive share ATM systems is in the public interest, although this could be the result if it is decided that shared ATM's are branches for all purposes. On the other hand, if the recent circuit court decision is left intact, an entire body of State law is preempted and the congressional concern over concentration of economic resources, which underlies the decentralization of control over structure, will be undercut. Only Congress can strike the balance between these valid, yet competing, public interests. The reinterpretation and reapplication of existing policies established by Congress is a role most properly reserved to Congress.

Five, States, unable to control national bank participation in shared systems, will be forced to limit corporate participation through State statutes designed to prevent deposit-taking as an agent for a bank. States can, of course, regulate commerce firms from engaging in a banking business. The valid State interest in controlling the mixing of banking and commerce parallels that of the Federal Government. In fact, the circuit court in the Marine case remanded for resolution by a State court the issue of

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whether the supermarket which owned the ATM in question was illegally conducting a banking business for resolution by a State court under State law. Unless Congress acts at this juncture, it is conceivable that States, unable to control banking activities through the McPadden Act, will seek to prohibit corporations that are not banks from taking deposits or performing other banking functions through ATM's on their own behalf or as an agent for a bank or bank holding company.

It is for all the above reasons that I introduced H.R. 2099 which would reestablish the principles embodied in the McPadden Act, yet do so in such a way as to permit existing ATM networks to continue to operate. I feel that it is important for Congress, not the courts, to strike the new balance and apply the public interest tests to emerging technologies such as ATM's. Briefly, the bill:

One, amends the McPadden Act to allow for national banks to branch on an interstate basis when the exporting State expressly authorizes out-of-State banks to establish interstate branches within its borders;

Two, restores the principle that State ATM laws are part of the branch banking laws of a State, made applicable to national banks by the McPadden Act;

Three, provides that shared ATM networks do not count toward capitalization of a bank; and

Four, provides a waiver procedure for the OCC to bypass the branch approval process for shared ATM networks.

H.R. 2099 is, in essence, a compromise measure, splitting the difference between competing constituencies and competing public interests. I would appreciate the support of each and every member of the House interested in expanding services for the banking consumer.

H.R. 2099

A bill to restore competitive equity between national and State banks regarding shared automatic teller machine networks

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as the "Automatic Teller Machine Competitive Equity Act of 1985".

SEC. 2. INTERSTATE BRANCHING.

The first sentence of section 5155(c) of the Revised Statutes (12 U.S.C. 36(c)) is amended—

(1) by striking out "and" before "(2)"; and

(2) by inserting before the period at the end thereof the following: "and (3) within any other State if—

"(A) the statute laws of the State in which the association is located expressly authorize State banks to establish such branches; and

"(B) the statute laws of the State in which the association is seeking to establish such interstate branches expressly authorizes State banks located in the State in which the association is located to establish such interstate branches, subject to restrictions

regarding location of branches that such State may impose on such out-of-State banks. In determining whether or to what extent to permit the establishment or operation of a branch by a bank the principal place of business of which is in another State, a State may allow such branching—

"(i) without restriction; or

"(ii) on the basis of—

"(I) the location of the States involved;

"(II) laws providing for reciprocal treatment of banks located in its State; or

"(III) other similar conditions or restrictions".

SEC. 3. STATE BRANCHING LAWS.

Section 5155(c) of the Revised Statutes (12 U.S.C. 36(c)) is amended by adding at the end thereof the following new sentence: "For purposes of this section, State laws applicable to automated teller machines, customer bank communication terminals, point-of-sale terminals, and cash dispensing machines are a part of the branch banking laws of the State and are applicable to national banking associations. In any case in which a State does not have a State law described in the preceding sentence, regulations, rulings, and interpretations which are issued by a State banking regulatory authority in such State and which are applicable to automated teller machines, customer bank communication terminals, point-of-sale terminals, and cash dispensing machines shall be deemed to be a part of the branch banking laws of the State and are applicable to national banking associations."

SEC. 4. AGGREGATE CAPITAL REQUIREMENTS.

Section 5155(d) of the Revised Statutes (12 U.S.C. 36(d)) is amended by adding at the end thereof the following new sentence: "For purposes of determining the aggregate capital required by this subsection, automated teller machines, customer bank communication terminals, point-of-sale terminals, and cash dispensing machines shall not be considered branches of a national banking association if they are not owned or rented by the national banking association."

SEC. 5. BRANCH APPROVAL.

Section 5155(e) of the Revised Statutes (12 U.S.C. 36(e)) is amended by adding at the end thereof the following new sentence: "The Comptroller of the Currency may, by regulation, waive the approval requirement of this subsection with regard to automated teller machines, customer bank communication terminals, point-of-sale terminals, and cash dispensing machines which are not owned or rented by a national banking association."

SECTION-BY-SECTION ANALYSIS

Section 1

Section 1 contains the short title of the bill, the "Automatic Teller Machine Competitive Equity Act of 1985."

Section 2

Section 2 would remove the absolute prohibition on interstate branching by national banks and give them parity with state banks in this regard. Under this provision, both interstate placement of ATM or brick and mortar branches and participation in interstate ATM networks would be permitted for national banks if state banks were allowed to do so under pertinent state laws.

Under Section 2 you have an exporting state, the state in which the association is located, and a receiving or importing state, "the state in which the association is seeking to establish such interstate branches". Two things must happen before interstate branching may occur:

(1) the exporting state must expressly authorize its banks to establish interstate branches, and

(2) the receiving state must expressly authorize out-of-state banks to establish interstate branches within its borders.

The receiving or importing state may reject interstate branching, it may permit such branching without restriction or it may make its statutory permission conditional.

Section 2 is a necessary part of the bill, since the absolute prohibition on interstate branching of national banks, as applied to ATM's under the relevant case law, would otherwise preclude their participation in interstate ATM networks. While the subject matter of the section is somewhat broader than mere ATM branches, it does nothing more than extend to national banks parity with state bank branching under state law. The practical effect is minimal, since only Massachusetts, Utah and Kentucky currently permit reciprocal interstate branching.

Section 3

Section 3 clarifies the status of ATM branches under the McPadden Act. It provides for the application of state laws to ATM's which perform banking functions irrespective of who owns them. By looking primarily to the functional definition of a branch (1) it ensures that the form of the agreements for system sharing will not be elevated to a position of greater importance than the substance of what is being done, (2) it prevents circumvention of the federal restriction on branch banking and (3) it reestablishes the applicability of the body of state laws regarding electronic banking.

The Supreme Court enunciated the principle that state law applicable to electronic banking devices is a part of the branch banking laws of the state, which is incorporated into the National Bank Act by the McPadden Act. That principle was undercut by a recent U.S. Court of Appeals decision which held that "... a national bank's use of a shared ATM which it does not own or rent, does not constitute the establishment and operation of a branch under Section 36(c) and (f) of the McPadden Act." By giving deference to the arbitrary distinction between ATM's "owned or rented" by national banks and those simply "used" by national banks for banking transactions, the Court ignored both the prohibition on interstate branching and the deference to state law which are fundamental to the McPadden Act. Unless this misapplication of federal law is rectified, full banking services may be offered by anyone, acting as an agent for a bank, on a nationwide basis without regard for the pertinent federal and state laws.

Section 3 reestablishes the principle enunciated by the Supreme Court and prevents its circumvention by the elevation of form over substance. It restores as the primary consideration the banking transactions which are being performed rather than the formal ownership of terminals. And, it does so in a way which permits existing interstate ATM networks to continue to operate.

Section 4

Section 4 would provide for the exclusion of ATM's not owned or rented by a bank from the determination of aggregate capital for that bank.

Section 5

Section 5 would give the OCC the authority to waive the branch approval process for ATM's which are not owned or rented by a bank.

April 18, 1985

CONGRESSIONAL RECORD — Extensions of Remarks

E 1595

SUMMARY OF *ISABYS v. MARINE MIDLAND*—
U.S. COURT OF APPEALS FOR THE SECOND
CIRCUIT, DECIDES FEBRUARY 27, 1985

Facts: Customers of Marine Midland Bank, N.A. (Marine) were using an automated teller machine owned by Wegmans Food Markets (Wegmans) to make deposits and cash withdrawals, to obtain cash advances against credit cards, transfer funds between accounts, pay bills and obtain account balance information. Under their agreement, Wegmans services the ATM and Marine operates the "switch" (central computer processing facilities) as a part of the Harmony shared ATM network. Marine is assessed fees on a transaction basis. The agreement between Marine and Wegmans was entered into in reliance on a regulation of the Comptroller which provided that an ATM was a branch only if it was "owned or rented" by a national bank.

Decision below: U.S. District Court for the Western District of New York enjoined Marine Midland Bank from using an ATM owned and operated by Wegmans Food Markets, 583 F. Supp. 1042 (1984). The district court held that Marine's use of the ATM constituted unauthorized branch banking under the McFadden Act.

Main issue: Whether the shared ATM in the Wegmans store is a branch established and operated by Marine.

Held: "... a national bank's usage of a shared ATM which it does not own or rent, does not constitute the establishment and operation of a branch under Sections 36(c) and (f) of the McFadden Act." **Subissue:** Whether Wegmans is conducting a banking business without the requisite state authorization.

Held: "... the application of New York Banking Law to Wegmans' provision and maintenance of an ATM should be left to the courts of the state. Accordingly, the judgment below for Wegmans on the pending claim is vacated, and the district court is instructed to dismiss that claim without prejudice."

Rationale: The question of whether a particular facility is a branch established and operated by a national bank under the McFadden Act is a question of federal law.

The Court sought to construe the meaning of the phrase "establish and operate" a "branch" under the McFadden Act. Since the Congress in 1927 could not have foreseen current developments in banking practices, a rigid application of the language of 1927 would lead to "anomalous results." Therefore the Court looked to legislative intent and "the views of the executive agency charged with the Act's enforcement."

The Court found that the governing principle behind the McFadden Act was competitive equality between state and national banks. On balance, the Court found that if shared ATM usage were deemed the "establishment" of a "branch" for purposes of federal law, national banks would be prohibited from interstate participation in shared networks which, in turn, would "limit the ability of national banks to compete in the use of major technological developments in this industry, contrary to Congressional purpose." (NOTE: The court seems to treat the prohibition on interstate branching as something to be overcome rather than as an integral part of the McFadden Act, evidencing Congressional intent contrary to the outcome of this case.)

Turning to the determinations of the OCC, the Court noted that the view of the administrative agency charged with enforcement is ordinarily entitled to "considerable respect." This is especially true where regulated parties have acted in reliance on the

agency's ruling and would be harmed by a reversal, as in this case. The Court found that the OCC interpretation appears to serve the purposes of the McFadden Act. (NOTE: Again, this finding appears correct only if you ignore evidence of Congressional intent to prohibit interstate banking.) Therefore, deference was accorded to the OCC determination that an ATM that is not "owned or rented" by a national bank is not a branch under the McFadden Act.

The Court did make note of the arbitrariness of the OCC distinction. It stated, "Whether an ATM is 'owned' or 'rented' or simply 'used' by a bank may be more a matter of how agreements are structured than a reliable determinant of whether or not the ATM constitutes a 'branch'." However, the Court found that the Comptroller's definition of "branch" in its 1982 regulation "is a reasonable construction of the McFadden Act."

The Court then spoke to the need for Congressional action:

"... Given the technological promise of interstate electronic banking and the substantial steps already taken toward achieving it, if the momentum already developed should be stopped, it should be done by Congress, and not by this court, particularly when the barrier we are asked to impose would be based upon definitions framed over 50 years ago."

"Should Congress find itself in disagreement with the Comptroller's Regulation, which we accept as a legitimate interpretation of the governing statute, a legislative solution is available." ■

CSBS POLICY ON SEPARATION OF BANKING AND COMMERCE

(Approved January 8, 1983 by the CSBS Board of Directors)

Introduction

The Conference of State Bank Supervisors (CSBS)--made up of the 53 state bank supervisors who charter and who are the primary examiners, regulators and supervisors of the approximately 10,500 state chartered banks holding nearly one-half of all bank assets of the nation--has a vital interest in and public responsibility toward the concept of the separation of banking and commerce. Therefore, CSBS adopts the following policy guides:

Banking and Commerce Relationship Criteria

In matters relating to the separation or mixing of banking and commerce, the following concepts shall guide CSBS actions:

1. In as much as economic, political and geographic circumstances vary from state to state, emphases appropriately placed on each criteria by each respective state relative to the mixing of banking and commerce will also vary. To serve best the public interest, CSBS criteria and the application thereof on a case-by-case basis will accommodate to this diversity.
2. In as much as a primary goal of CSBS policies and actions is to encourage banks to provide needed financial services, CSBS encourages flexibility in banking powers and services to the full extent consistent with bankings' primary functions, responsibilities and roles in the economy.
3. In as much as banks, along with certain other depository institutions, have traditionally been recognized as unique in that they broadly assemble funds from essentially one and all in respective trade areas and provide demand deposit services required for day-to-day transactions, banks have a public trust which demands that safety and soundness continue to be emphasized.
4. These same characteristics which bestow on banks a public trust also demand that banks be without conflicts of interest and bias in allocating financial resources entrusted to them.
5. In as much as "money" inherently is vulnerable to concentration and centralized control with possible abuses attendant thereto and for all practical purposes has no near substitute, the public interest demands that undue concentrations of banking with commerce be avoided.
6. In as much as money has an inherently unique power, only financial activities which are appropriate adjuncts to providing financial services, with emphasis on the criteria set forth in 3, 4 and 5 above, should be "mixed" with banking.

7. Equitable treatment should be evaluated on an overall basis and not misconstrued or confused with equal or sameness of services and powers: banks remain distinct in fundamental, public interest ways from other financial institutions notwithstanding recent legislation.

Therefore, in order for the banking system to compete equitably with other types of institutions, banking should be granted certain new powers or other types of institutions denied certain powers in those circumstances in which inequity exists. Competitive inequity can adversely affect safety and soundness.

8. To the extent new powers may be granted to banks to provide needed services or to permit banks to compete equitably, appropriate quantitative and/or qualitative limitations should be established to assure safety and soundness, unbiased allocation of financial resources and freedom from undue concentrations of financial or economic resources.

In summary, CSBS believes greater flexibility may be needed in selected areas (criteria 1 and 2), certain public interest guides must be respected (criteria 3 through 7) and to the extent any essential flexibility may be inconsistent with one or more broader public interest guides, definitive limitations must be imposed (criterion 8).

To the extent any two or more of the above criteria may be inconsistent with one another when applied to specific situations, each proposed service or power must be weighed by CSBS against subject criteria and a judgment reached as to a maximization of the public interest or the least imperfection in serving the public interest.

The CHAIRMAN. Thank you, Mr. Bailey.
Mr. Bergman.

STATEMENT OF WILLIAM S. BERGMAN, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF STATE SAVINGS & LOAN SUPERVISORS

Mr. BERGMAN. Thank you, Mr. Chairman. My name is William S. Bergman. I am the executive vice president of the National Association of State Savings & Loan Supervisors, a position that I have held for over 17 years.

At this time, Mr. Chairman, with your permission, I would like to highlight my testimony, but I would ask that it be printed in its entirety if that's all right.

The CHAIRMAN. It will be.

[The complete prepared statement follows:]

STATEMENT OF
WILLIAM S. BERGMAN, CAE
EXECUTIVE VICE PRESIDENT
THE NATIONAL ASSOCIATION OF STATE SAVINGS AND
LOAN SUPERVISORS*

BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

MAY 14, 1985

*The members of the National Association of State Savings and Loan Supervisors are the state officials who regulate state-chartered savings and loan institutions in the several states and territories. The members of NASS&LS supervise and examine some 2,300 state-chartered institutions with assets of approximately \$250 billion. The members of the Board of Directors of NASS&LS are: L.L. Bowman III, Commissioner of the Department of Savings and Loans, State of Texas; George C. King, Administrator of the Savings and Loan Division, State of North Carolina; David L. Paul, Commissioner of the Division of Savings and Loan, State of Colorado; Charles H. Brown, Jr., Director of the Division of Savings and Loans, State of Maryland; William B. Lewis, Deputy Commissioner of the Division of Savings and Loan Associations, State of New Jersey; and Elaine B. Weis, Commissioner of the Department of Financial Institutions, State of Utah.

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THIS COMMITTEE, MY NAME IS WILLIAM S. BERGMAN AND I AM EXECUTIVE VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS. I GREATLY APPRECIATE THIS OPPORTUNITY TO PROVIDE THE VIEWS OF NASS&LS REGARDING WHAT WE BELIEVE TO BE THE APPROPRIATE LEGISLATIVE RESPONSES TO THE ONGOING, RAPID CHANGES IN OUR NATION'S FINANCIAL SERVICES INDUSTRY. MY TESTIMONY TODAY WILL FOCUS PRIMARILY ON THE SAVINGS AND LOAN INDUSTRY AND ITS STATUS AS AN INTEGRAL ELEMENT OF THIS COUNTRY'S FINANCIAL SERVICES INDUSTRY AND ON THOSE PROPOSALS PRESENTLY BEFORE THIS CONGRESS WHICH DIRECTLY AFFECT STATE REGULATION, STATE CHARTERED SAVINGS AND LOAN ASSOCIATIONS AND THE DUAL SYSTEM OF FINANCIAL INSTITUTION REGULATION. I WILL BRIEFLY TOUCH UPON CERTAIN ISSUES WHICH THE MEMBERS OF THIS COMMITTEE ARE ALREADY FAMILIAR WITH BUT, WHICH WARRANT RESTATING HERE SO THAT THE MAGNITUDE OF THEIR IMPORTANCE IS FULLY PERCEIVED. MANY OF THESE ISSUES HAVE PREVIOUSLY BEEN CONSIDERED BY NOT ONLY THIS COMMITTEE BUT ALSO OTHER CONGRESSIONAL COMMITTEES AND THE VARIOUS FEDERAL AND STATE FINANCIAL INSTITUTION REGULATORY AUTHORITIES.

RESTRICTIONS ON STATE-CHARTERED THRIFT INSTITUTIONS

ON MAY 3, 1985, THE FEDERAL HOME LOAN BANK BOARD FORWARDED TO THIS COMMITTEE CERTAIN LEGISLATIVE PROPOSALS INTENDED TO SUPPLEMENT THE PROVISIONS OF SENATE BILL S.759 WHICH WAS RECENTLY INTRODUCED BY THE CHAIRMAN AND MR. PROXHIRE AT THE REQUEST OF THE FHLBB. LEAVING AN IN-DEPTH ANALYSIS OF SENATE BILL S.759 FOR ANOTHER TIME, I WILL SIMPLY SAY THAT SENATE BILL S.759 IS A COMPREHENSIVE PIECE OF LEGISLATION DESIGNED TO ADDRESS MANY OF THE CONCERNS PRESENTLY HELD BY THE FHLBB. HOWEVER, DUE TO THEIR SEVERITY, I CANNOT HELP BUT COMMENT ON TWO OF THE PROPOSALS SUBMITTED TO THIS COMMITTEE BY THE FHLBB ON MAY 3RD. THE FIRST

PROPOSAL WOULD, AMONG OTHER THINGS, REQUIRE THE FSIC TO REJECT AN APPLICATION FOR INSURANCE OF ACCOUNTS IF IT WAS DETERMINED THAT THERE WAS NO NECESSITY FOR THE APPLICANT THRIFT INSTITUTION IN THE COMMUNITY TO BE SERVED. THE EVALUATION OF SUCH "NEED" CRITERIA FOR STATE CHARTERED APPLICANTS HAS, TRADITIONALLY, BEEN THE PROVINCE OF THE STATE SAVINGS AND LOAN SUPERVISOR. THE SECOND PROPOSAL WHICH I WISH TO TOUCH UPON PROHIBITS STATE-CHARTERED FSIC-INSURED THRIFT INSTITUTIONS FROM ENGAGING IN ANY ACTIVITY NOT OF A TYPE OR IN EXCESS OF THE LEVEL PERMITTED FOR FEDERALLY-CHARTERED THRIFT INSTITUTIONS, FOR MULTIPLE SAVINGS AND LOAN HOLDING COMPANIES, OR BY THE FSIC, BY REGULATION. THIS PROPOSAL FOLLOWS QUICKLY UPON THE HEELS OF THE FHLBB'S RECENTLY PROMULGATED REGULATION LIMITING, NOTWITHSTANDING STATE LAW, THE DIRECT INVESTMENT AUTHORITY OF ALL FSIC-INSURED INSTITUTIONS. THESE LEGISLATIVE PROPOSALS, IF ENACTED, WILL FURTHER ERODE THE STATUTORY FRAMEWORK AND REGULATORY STRUCTURE DEvised BY THE VARIOUS STATE LEGISLATURES RELATING TO STATE-CHARTERED THRIFT INSTITUTIONS.

AN ESSENTIAL CHARACTERISTIC OF THE AMERICAN FINANCIAL INSTITUTIONS SYSTEM IS THE CHOICE OF FEDERAL OR STATE CHARTER, BROADLY REFERRED TO AS THE "DUAL SYSTEM." THE AUTHORIZATION OF FEDERAL CHARTERS WAS NOT TO REPLACE OR NECESSARILY TO COMPETE WITH STATE INSTITUTIONS, BUT TO FILL A NEED IN LOCAL AREAS WHERE NO INSTITUTION EXISTED AT ALL. THIS SYSTEM HAS BEEN THE LIFE BLOOD OF OUR BANKING AND FINANCIAL SERVICES INDUSTRY. NO ONE CAN QUESTION THE BENEFITS WHICH HAVE INURED AS A RESULT OF THE DUAL SYSTEM OF CHARTERING AND REGULATION. THE VARIOUS STATES HAVE TIME AND TIME AGAIN PROVIDED INNOVATIVE CHANGE WHICH HAS ULTIMATELY FOUND ITS WAY INTO THE NATIONAL BANKING SYSTEM.

OVER THE YEARS, MANY CRITICS OF THE DUAL SYSTEM HAVE UNDERSCORED THE NEED FOR A PERVERSIVE SYSTEM OF FINANCIAL INSTITUTIONS REGULATION IN OUR COUNTRY AND THAT IT IS INCUMBENT UPON THE FEDERAL GOVERNMENT TO SUPPLY SUCH A SYSTEM. THE BASIS OF THE PROPOSAL IS THAT THERE SHOULD BE A NATIONAL SYSTEM OF FINANCIAL INSTITUTION REGULATION. CONGRESS AND THE BUSH TASK FORCE HAVE BOTH REJECTED THIS PROPOSAL AND HAVE REAFFIRMED THEIR BELIEF IN A DECENTRALIZED DUAL SYSTEM OF REGULATION.

THERE ARE FOUR RATHER COMPELLING REASONS WHY THE DUAL SYSTEM SHOULD NOT BE RELINQUISHED. THE FIRST IS OBVIOUS, BUT VERY IMPORTANT. IT IS THE VIEW OF MANY THAT DECISIONS MADE CLOSER TO HOME ARE BETTER DECISIONS. GENERALLY, THRIFT INSTITUTION MANAGERMENTS DO NOT RELISH THE PROSPECT OF HAVING TO WAIT FOR WASHINGTON ACTION ON DECISIONS OF IMPORTANCE TO AN INSTITUTION LOCATED IN PUEBLO, COLORADO. LIFE IS TOO SHORT TO SPEND IT WAITING FOR A DECISION TO BE MADE 2,000 MILES AWAY IN AN ENVIRONMENT WHICH HAS NO NECESSARY KNOWLEDGE OF OR EMPATHY FOR THE NEEDS AND CONCERNS OF THE PEOPLE AFFECTED. SECOND, IT SEEMS THAT IF A DUAL SYSTEM HAS PROVED ANYTHING, AND CONTINUES TO PROVE SOMETHING, IT IS THAT OUT OF DIVERSITY COMES STRENGTH. THE FACT THAT THERE ARE TWO SEPARATE SYSTEMS OF FINANCIAL INSTITUTIONS BREEDS DISSIMILARITY AND OUT OF THAT DISSIMILARITY COMES DIFFERING EXPERIENCE. FROM THAT DIFFERING EXPERIENCE WE CAN LEARN. IF ALL THRIFT INSTITUTIONS WERE SUBJECT TO ONE SET OF REGULATIONS, ONE SET OF LAWS AND ONE SET OF REGULATORS, THAT UNIFORMITY WOULD TEND TO STIFLE INNOVATION. CONSUMER PRODUCTS SUCH AS NOW ACCOUNTS, DEREGULATED INTEREST ON SAVINGS DEPOSITS AND VARIABLE RATE MORTGAGES WERE ALL DEVELOPED BY STATE-INSURED INSTITUTIONS BEFORE THEY WERE PERMITTED BY FEDERAL DEPOSIT INSURANCE

REGULATIONS. THE EXISTENCE OF THESE INSTITUTIONS HAS PROVIDED A LABORATORY FOR THE DEVELOPMENT OF NEW FINANCIAL PRODUCTS, WHICH HAVE ENCOURAGED HEALTHY COMPETITION AND MADE OUR NATION'S FINANCIAL SYSTEM MORE INNOVATIVE WITH DIRECT BENEFIT TO THE CONSUMER. THIRD, COMPETITION BETWEEN STATE AND FEDERALLY CHARTERED INSTITUTIONS IS A HIGHLY DESIRABLE CONDITION AND HAS AS ITS BY-PRODUCT BETTER PERFORMANCE. FOURTH, IT MAY NOT BE COINCIDENTAL THAT OUR COUNTRY, CHARACTERIZED AS IT IS BY A MINIMUM LEVEL OF GOVERNMENTAL INTERVENTION IN THE AFFAIRS OF FINANCIAL INSTITUTIONS, HAS ENJOYED REMARKABLE PROSPERITY. UNLIKE OUR EUROPEAN AND ASIAN COUNTERPARTS, OUR FINANCIAL INSTITUTIONS OPERATE WITHOUT GOVERNMENT INTERVENTION IN THE ESTABLISHMENT OF CREDIT ALLOCATION PRIORITIES. OUR FINANCIAL INSTITUTIONS, WITH ONLY FEW EXCEPTIONS, HAVE NOT BEEN REQUIRED TO FUNCTION AS PURVEYORS OF GOVERNMENTAL ASSISTANCE. OUR FINANCIAL INSTITUTIONS REMAIN PREDOMINANTLY PRIVATE ENTERPRISE INSTITUTIONS WHOSE POLICIES ARE DICTATED BY THOSE IN POSITIONS OF OWNERSHIP AND CONTROL.

IN SHORT, THE DUAL SYSTEM WORKS IN ASSURING THAT SERVICES NEEDED IN A PARTICULAR AREA OF THE COUNTRY OR BY A PARTICULAR TYPE OF INSTITUTION ARE BEING PROVIDED. THE EXISTENCE OF THE CHOICE AND THE AVAILABILITY TO AN INSTITUTION TO CHANGE CHARTERS HAS RESULTED IN MORE FLEXIBLE AND RESPONSIVE SUPERVISION AND BETTER SOCIAL PERFORMANCE AS WELL AS MORE INNOVATIVE FINANCIAL SERVICES BY COMPARISON WITH THE SOCIAL PERFORMANCE OF INDUSTRIES SUBJECT TO A UNIFIED REGULATORY STRUCTURE. RESERVING TO THE FEDERAL REGULATORS THE DETERMINATION OF WHEN THERE IS A "NEED" FOR A STATE-CHARTERED, FSLIC-INSURED THRIFT INSTITUTION AND LIMITING THE ENTIRE SAVINGS AND LOAN INDUSTRY TO THE ACTIVITIES AUTHORIZED TO FEDERALLY-CHARTERED THRIFT INSTITUTIONS IS A BACK-DOOR MEANS OF FEDERALIZING THE

SAVINGS AND LOAN INDUSTRY AND MAY BE VIEWED AS THE FIRST STEP TO A CONCENTRATION OF ECONOMIC POWER, WHICH WE ALL SO DEEPLY FEAR. SUCH A FUNDAMENTAL CHANGE IN OUR BANKING SYSTEM, AS WELL AS SUCH A COMPREHENSIVE TRANSGRESSION OF STATES RIGHTS SHOULD OCCUR ONLY AFTER CAREFUL EXAMINATION.

CAPITAL ADEQUACY

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, LET ME STATE CATEGORICALLY THAT NASS&LS IS SECOND TO NONE IN ITS CONCERN FOR THE CAPITAL ADEQUACY OF THE THRIFT INDUSTRY. THE LESS-THAN-DESIRABLE CAPITAL STRUCTURE OF THE THRIFT INDUSTRY AS IT EXISTS IN 1985, AND THE RESULTING THREAT TO A DEPLETED FSLIC FUND ARE ISSUES ABOUT WHICH WE SHOULD ALL BE DEEPLY CONCERNED. I WOULD LIKE TO EMPHASIZE NASS&LS' AND MY CONCERN FOR THE CONTINUED SAFETY AND SOUNDNESS OF THE FSLIC FUND AS WELL AS THE NEED TO PROTECT IT. IT IS IN NASS&LS' BEST INTEREST, AS WELL AS THE INSTITUTIONS WHICH ITS MEMBERS REGULATE, TO MAINTAIN THE INTEGRITY OF THE FSLIC FUND AND THE DEPOSITS THAT IT INSURES. A SOUND, DIVERSIFIED, WELL CAPITALIZED INDUSTRY WITH A HEALTHY INSURANCE FUND BEHIND IT IS WHAT WE ALL DESIRE.

IN AN EFFORT TO PRESERVE AND STRENGTHEN THE CAPITAL POSITION OF THE THRIFT INDUSTRY, NASS&LS STRONGLY SUPPORTS THE EXTENSION OF THE NET WORTH CERTIFICATE PROGRAM CONTAINED IN THE DEPOSITORY INSTITUTIONS ACT OF 1982, THE SO-CALLED "GARN-ST GERMAIN ACT." EXTENSION OF THIS PROGRAM WILL LIKELY PERMIT THE RESTRUCTURING AND RECAPITALIZATION THAT IS OCCURRING IN THE THRIFT INDUSTRY TO CONTINUE ON AN UNINTERRUPTED BASIS. EXTINGUISHING THIS PROGRAM COULD NEGATIVELY IMPACT THIS ONGOING PROCESS. ADDITIONALLY, NASS&LS SUPPORTS THE EXTENSION OF

THE PROVISIONS OF THE GARN-ST GERMAIN ACT RELATIVE TO EMERGENCY THRIFT ACQUISITIONS. THIS PROVISION HAS BEEN EXTREMELY USEFUL IN LIMITING THE POTENTIAL IMPACT TO THE FSLIC FUND AND HAS PERMITTED HEALTHY, VIABLE THRIFT INSTITUTIONS AND SAVINGS AND LOAN HOLDING COMPANIES TO ASSIST THE REGULATORS IN RESOLVING DIFFICULT SITUATIONS. EXTENSION OF THIS PROVISION WILL CONTINUE TO PERMIT A MORE ORDERLY RESTRUCTURING OF THE CAPITAL POSITION OF THE THRIFT INDUSTRY AS A WHOLE AND THEREBY REMOVE A CERTAIN DEGREE OF PRESSURE FROM THE FSLIC-FUND.

REALIGNMENT OF THE REGULATORY FRAMEWORK OF FINANCIAL INSTITUTIONS

NASS&LS COMMENDS THE MEMBERS OF THIS COMMITTEE FOR ADDRESSING IN A COMPREHENSIVE FRAMEWORK THE DIFFICULT AND CONTROVERSIAL ISSUES OF FINANCIAL INSTITUTION DEREGULATION. ALTHOUGH SENATE BILL S-2857 WAS NOT ENACTED LAST YEAR, I AM CONFIDENT THAT THE SENATE'S COMMITMENT TO LEGISLATIVELY DIRECT THE RESTRUCTURING OF THE FINANCIAL SERVICES INDUSTRY HAS NOT BEEN DAMPENED. THIS COMMITTEE UNDERSTANDS THAT THE LEGAL AND REGULATORY FRAMEWORK OF FINANCIAL INSTITUTIONS SHOULD NOT BE DETERMINED SOLELY BY THE MARKETPLACE, OR BY REGULATORY FIAT, BUT BY NECESSARY AND REASONED STATUTORY ACTION BASED UPON FULL AND FAIR CONSIDERATION OF ALL FACTORS. NASS&LS SUPPORTS LEGISLATIVE PROPOSALS WHICH WOULD CHARACTERIZE FINANCIAL INSTITUTIONS BY THE TYPE OF ACTIVITIES IN WHICH THEY ENGAGE AS WELL AS DETERMINE THE PROPER REGULATORY AGENCY TO OVERSEE SUCH INSTITUTIONS. BASICALLY, WE FEEL THAT IF AN INSTITUTION ACTS LIKE A BANK THEN IT SHOULD BE REGULATED AS ONE, WHEREAS IF AN INSTITUTION ENGAGES IN ACTIVITIES WHICH ARE GENERALLY VIEWED AS CHARACTERISTIC OF THE THRIFT INDUSTRY,

THEN IT SHOULD BE REGULATED AS A THRIFT INSTITUTION REGARDLESS OF ITS NAME OR CHARTER. A GOOD EXAMPLE OF THIS IS THE AMENDATORY PROVISION IN SECTION 108 OF SENATE BILL S.2819, WHICH WOULD AMEND THE DEFINITION OF "INSURED INSTITUTION" IN THE SAVINGS AND LOAN HOLDING COMPANY ACT TO INCLUDE STATE-CHARTERED, FDIC-INSURED STOCK SAVINGS BANKS. THE EFFECT OF SUCH AN AMENDMENT WOULD SUBJECT THE HOLDING COMPANIES OF SUCH INSTITUTIONS TO THE PROVISIONS OF THE SAVINGS AND LOAN HOLDING COMPANY ACT AND THE AUTHORITY OF THE FHLBB, RATHER THAN THE BANK HOLDING COMPANY ACT AND THE FEDERAL RESERVE BOARD. THIS DEFINITIONAL CHANGE SERVES TO REALIGN THOSE INSTITUTIONS WITHIN THE PROPER REGULATORY FRAMEWORK BASED UPON THEIR ACTIVITIES IN THE FINANCIAL MARKETPLACE AND NOT BASED UPON THEIR NAME OR TYPE OF CHARTER.

WE ALSO STRONGLY SUPPORT THE CONCEPT OF A DEFINITIONAL TEST OF A "QUALIFIED THRIFT LENDER" IN SETTING MINIMUM GUIDELINES FOR DETERMINING WHETHER A PARTICULAR INSTITUTION IS A THRIFT. NASS&LS BELIEVES THAT THE PRIMARY ROLE OF THRIFT INSTITUTIONS IS TO SERVE THE HOUSING FINANCE NEEDS OF THE AMERICAN PEOPLE. IF THESE NEEDS ARE NOT BEING MET BY A PARTICULAR INSTITUTION DUE TO A CONCENTRATION OF ITS INVESTMENTS IN OTHER AREAS, THEN PERHAPS THE INSTITUTION SHOULD BE FORCED TO DECIDE THE TYPE OF SERVICES AND REGULATORY FRAMEWORK IN WHICH IT WISHES TO OPERATE.

ALTHOUGH NASS&LS SUPPORTS THE THRIFT INDUSTRY'S COMMITMENT TO HOUSING FINANCE, DIVERSIFIED INVESTMENT AUTHORITY IS CRITICAL TO THE LONG-TERM VIABILITY OF THE THRIFT INDUSTRY. THIS NEED FOR DIVERSIFICATION WAS CLEARLY RECOGNIZED IN THE GARN-ST GERMAIN ACT WHICH ENABLED FEDERAL THRIFT INSTITUTIONS TO INVOLVE

THEMSELVES IN COMMERCIAL LENDING AND OTHER BANK-LIKE ACTIVITIES, IN A LIMITED WAY, IN ORDER TO PERMIT SUCH INSTITUTIONS TO EFFECTIVELY COMPETE IN THE FINANCIAL MARKETS. THESE SPECIFIC PROVISIONS, WHICH ARE ENJOYED BY MANY STATE-CHARTERED INSTITUTIONS, BY SPECIFIC STATE LAW OR PARITY STATUTES, PROVIDE A NEW MEASURE OF ASSET FLEXIBILITY TO SUPPLEMENT THEIR PRINCIPAL ROLE OF MORTGAGE AND REAL ESTATE FINANCE. DIVERSIFICATION OF INVESTMENTS TO A CERTAIN EXTENT IS NECESSARY FOR THE THRIFT INDUSTRY TO AVOID THE DEVASTATING MISMATCHING OF ITS ASSETS AND LIABILITIES. THE THRIFT INDUSTRY RECENTLY EXPERIENCED THE IMPACT OF SUCH MISMATCHING AND WE HAVE AN OBLIGATION AS REGULATORS TO ASSIST THE INDUSTRY IN MINIMIZING ITS VULNERABILITY TO INTEREST RATE SWINGS. ALTHOUGH THE ADDITIONAL POWERS MENTIONED ABOVE HAVE ENABLED THRIFT INSTITUTIONS TO COMPETE IN THE NEW FINANCIAL SERVICES ENVIRONMENT, IT IS IMPERATIVE THAT WE RECOGNIZE THAT THE THRIFT INDUSTRY IS STILL COMMITTED TO OFFERING AND INVESTING IN HOME MORTGAGE AND HOUSING FINANCE. NASS&LS, AND THE INSTITUTIONS WHICH IT REGULATES, RECOGNIZE AND ENDORSE THE NEED FOR THIS CONTINUING COMMITMENT. HOWEVER, WE ALSO RECOGNIZE THE FACT THAT THE THRIFT INDUSTRY IS STILL FRAGILE AND THAT A BALANCE MUST BE STRUCK BETWEEN THE NEED FOR HOUSING AND THE NEED FOR THRIFT INSTITUTIONS TO DIVERSIFY THEIR INVESTMENTS IN ORDER TO ASSURE THEIR CONTINUING SAFETY AND SOUNDNESS. AS SUCH, NASS&LS SUPPORTS THE CONCEPT OF A THRIFTNESS TEST WHEREBY 60% OF A THRIFT INSTITUTION'S ASSETS ARE REQUIRED TO BE IN RESIDENTIAL MORTGAGES AND RELATED INVESTMENTS.

PRODUCT CONSIDERATIONS

NASS&LS IS ALSO IN SUPPORT OF THE PAYMENT OF INTEREST BY DEPOSITORY INSTITUTIONS ON DEMAND DEPOSITS. AN ESSENTIAL ROLE AND RESPONSIBILITY OF A DEPOSITORY INSTITUTION HAS BEEN TO MARKET AND GATHER DEPOSITS. CURRENTLY, HOWEVER, MOST THRIFT INSTITUTIONS ARE BASICALLY LIMITED TO OFFERING DEMAND DEPOSITS ONLY TO THOSE BUSINESS CUSTOMERS WITH WHICH THE INSTITUTION HAS A LOAN RELATIONSHIP. IF THIS RESTRAINT COULD BE REMOVED IN CONJUNCTION WITH ALLOWING INTEREST ON DEMAND DEPOSITS, THRIFT INSTITUTIONS WOULD BE ABLE TO COMPETE FOR DEPOSIT DOLLARS, FOR THE FIRST TIME, ON AN EQUITABLE BASIS WITH COMMERCIAL BANKS. AS WE ALL ACKNOWLEDGE, SUCH DEPOSIT DOLLARS ARE A NECESSARY MEANS TO ENABLE THRIFT INSTITUTIONS TO CONTINUE TO PROVIDE MONEY FOR HOUSING. THE COMPETITIVE BENEFITS THAT HAVE ALREADY ACCRUED TO THE THRIFT INDUSTRY IN LIGHT OF THE MMDA AND NOW ACCOUNTS ARE THE MOST PERSUASIVE ARGUMENT FOR CONTINUED DEREGULATION IN THIS AREA. A SUBSTANTIAL PART OF THE GROWTH IN RETAIL DEPOSIT BALANCES IN THRIFT INSTITUTIONS REPRESENTS FUNDS PLACED IN THESE TWO ACCOUNTS. THEREFORE, NASS&LS URGES THE COMMITTEE TO REMOVE THE CURRENT DEMAND DEPOSIT OFFERING RESTRAINT AND THE PROHIBITION ON THE PAYMENT OF INTEREST ON DEMAND DEPOSITS. THE REMOVAL OF THESE RESTRICTIONS WOULD PROVIDE BENEFITS IN COMPETITIVE EFFICIENCY AND CONSUMER CHOICE WHICH WOULD FAR OUTWEIGH ANY TRADITIONAL EARNINGS PRESSURE ON FINANCIAL INSTITUTIONS. IN ADDITION, IT WOULD PERMIT THRIFT INSTITUTIONS TO TRULY COMPETE AND SOLICIT DEPOSITS ON THE SAME BASIS AS COMMERCIAL BANKS.

ON A RELATED ISSUE, NASS&LS SUPPORTS INITIATIVES TO REQUIRE THE FEDERAL RESERVE BOARD TO PAY INTEREST ON RESERVES NOW HELD AGAINST DEMAND DEPOSITS.

PAYING INTEREST ON THESE FUNDS WOULD HELP TO OFFSET THE INCREASED COST FOR FUNDS ACCOMPANYING DEMAND ACCOUNT DEREGULATION, AND WOULD ALLOW DEPOSITORIES TO PASS COST SAVINGS ALONG TO CUSTOMERS.

IN RECENT YEARS, THRIFT INSTITUTIONS HAVE BEEN GIVEN THE AUTHORITY TO ORIGINATE AND PURCHASE MORTGAGE LOANS WHICH PROVIDE FOR PERIODIC INTEREST RATE ADJUSTMENTS. INSTITUTIONS WHICH HAVE AVAILED THEMSELVES OF THIS EXPANDED AUTHORITY HAVE SUCCESSFULLY REDUCED THE POTENTIAL IMPACT ON THEIR OPERATIONS DUE TO A RAPID INCREASE IN MARKET RATES OF INTEREST. NASS&LS IS OPPOSED TO THE PROPOSAL, ADOPTION OR ENACTMENT OF ANY FEDERAL LEGISLATION OR REGULATION WHICH WOULD RESTRICT, IN ANY UNREASONABLE MANNER, THE AUTHORITY OF THRIFT INSTITUTIONS TO OFFER MORTGAGE LOANS WHICH PROVIDE FOR PERIODIC INTEREST RATE ADJUSTMENTS.

NASS&LS, AS PART OF ITS OVERALL CONCERN FOR THE SAFETY AND SOUNDNESS OF THE FSLIC FUND, IS CONCERNED WITH THE INCREASED RISK OF SOME THRIFT INSTITUTION ENDEAVORS. NASS&LS BELIEVES THAT THE THRIFT INDUSTRY WOULD BE BETTER SERVED IF A SET OF MONITORING DEVICES COULD BE IMPLEMENTED TO CHECK THE PROFITABILITY OF THRIFT INSTITUTIONS AND THE RISK ASSOCIATED WITH THE ACTIVITIES IN WHICH THEY ENGAGE. NASS&LS SUPPORTS THE INTRODUCTION OF AND REQUESTS THAT THE COMMITTEE CONSIDER LEGISLATION DIRECTING THE FSLIC TO PROMULGATE REGULATIONS WHICH WOULD REQUIRE FSLIC-INSURED INSTITUTIONS TO MAINTAIN A LEVEL OF NET WORTH BASED UPON THE RISK ASSOCIATED WITH THE ENGAGEMENT "IN CERTAIN ACTIVITIES BY SUCH INSTITUTIONS.

GEOGRAPHIC CONSIDERATIONS

NON-REGULATED FINANCIAL SERVICE PROVIDERS, THROUGH CIRCUMVENTION OF FEDERAL AND STATE LAW AND REGULATION, HAVE BEEN ABLE TO ESTABLISH A NATIONWIDE NETWORK OF FINANCIAL INTERMEDIATION. THIS NATIONWIDE NETWORK OF FINANCIAL INTERMEDIATION, WITH ITS FLEXIBILITY AND ECONOMIES OF SCALE, HAS BEEN ABLE TO PROVIDE LESS COSTLY AND MORE EFFICIENT FINANCIAL SERVICES TO THE AMERICAN PUBLIC IN DIRECT COMPETITION WITH REGULATED DEPOSITORY INSTITUTIONS. CONGRESS, IN ENACTING THE GARN-ST GERMAIN ACT, ACKNOWLEDGED THIS INEQUITY AND AUTHORIZED INTERSTATE BRANCHING FOR FEDERALLY-CHARTERED THRIFT INSTITUTIONS, SUBJECT TO THE AUTHORITY GRANTED PURSUANT TO STATE LAW. NASS&LS SUPPORTS THIS MOVEMENT AND RECOMMENDS THAT THE FHLBB PROMULGATE A REGULATION CRAFTED IN A FASHION WHICH WOULD CONDITION THE ABILITY OF A FEDERALLY-CHARTERED THRIFT INSTITUTION TO BRANCH INTERSTATE, UPON A CERTIFICATION BY THE STATE REGULATOR THAT STATE LAW PERMITS THE ENTRY OF OUT-OF-STATE INSTITUTIONS. IN CONJUNCTION WITH THIS FEDERAL ACTION, NASS&LS WOULD URGE EACH OF ITS ACTIVE MEMBERS TO RESPOND TO THE EVOLVING NATIONWIDE FINANCIAL MARKETPLACE BY SEEKING THE REMOVAL OF ALL EXISTING BARRIERS OF STATE LAW TO THE INTERSTATE BRANCHING OF STATE-CHARTERED THRIFT INSTITUTIONS THROUGH THE ENACTMENT OF NATIONWIDE OR REGIONAL COMPACTS OR OTHER LEGISLATIVE ENACTMENTS.

DEFINITION OF THE TERM "BANK"

NASS&LS WOULD ALSO LIKE TO ADDRESS THE EXPANSION OF THE DEFINITION OF THE TERM "BANK" FOR PURPOSES OF THE BANK HOLDING COMPANY ACT. NASS&LS SUPPORTS THE CLOSING OF THE NON-BANK BANK LOOPHOLE BY REDEFINING THE TERM "BANK." HOWEVER,

REGULATION OF STATE-REGULATED THRIFT INSTITUTIONS BY THE FEDERAL RESERVE BANK UNDER THE BANK HOLDING COMPANY ACT HAS NOT HISTORICALLY BEEN REQUIRED, NOR IS IT NOW REQUIRED, TO PROTECT THE NATION'S DEPOSITORY SYSTEM. STATE REGULATORS, BY STATUTE, REGULATION AND REGULATORY PRACTICE, HAVE PROHIBITED AND WILL CONTINUE TO PROHIBIT SUCH TRANSACTIONS AS WOULD RESULT IN DISCRIMINATION IN THE GRANTING OF CREDIT, CONFLICTS OF INTEREST AND RISK TO THE FINANCIAL DEPOSITORY SYSTEM INHERENT IN THE UNLIMITED ASSOCIATION OF BANKING AND COMMERCE.

SAVINGS AND LOAN HOLDING COMPANIES

IN ADDITION TO CLOSING THE NON-BANK BANK LOOPHOLE, CERTAIN LEGISLATIVE PROPOSALS WOULD ALSO TIE THE THRIFTNESS TEST DISCUSSED ABOVE TO THE ABILITY OF UNITARY SAVINGS AND LOAN HOLDING COMPANIES TO DIVERSIFY INTO OTHER INDUSTRIES. IT HAS BEEN PROPOSED THAT THRIFT INSTITUTIONS HELD BY UNITARY SAVINGS AND LOAN HOLDING COMPANIES WOULD HAVE TO MEET THAT TEST OR THE HOLDING COMPANY WOULD BE PROHIBITED FROM INITIATING OR CONTINUING ANY BUSINESS ACTIVITY NOT PERMITTED TO BE ENGAGED IN BY A MULTIPLE SAVINGS AND LOAN HOLDING COMPANY. THE LEGISLATION WOULD ALSO PROHIBIT THRIFT INSTITUTIONS HELD BY UNITARY SAVINGS AND LOAN HOLDING COMPANIES FROM ENGAGING IN COMMERCIAL LENDING IF THEIR PARENT COMPANY ENGAGES IN ACTIVITIES NOT PERMISSIBLE FOR MULTIPLE SAVINGS AND LOAN HOLDING COMPANIES.

NASS&LS DOES NOT UNDERSTAND WHY IT IS NECESSARY TO ADDRESS THE SAVINGS AND LOAN HOLDING COMPANY PROVISIONS OF THE NATIONAL HOUSING ACT. THOSE PROVISIONS, IN THEIR PRESENT FORM, HAVE SUCCESSFULLY PROVIDED A COMPREHENSIVE STATUTORY FRAMEWORK FOR THE REGISTRATION, EXAMINATION AND REGULATION OF HOLDING COMPANIES CONTROLLING ONE OR MORE THRIFT INSTITUTIONS. WE SEE NO NEED TO TINKER WITH A

STATUTE WHICH IS ADEQUATELY MEETING THE NEEDS OF THE REGULATORS IN DEALING WITH ANY PROBLEMS SURROUNDING HOLDING COMPANIES. THE SAVINGS AND LOAN HOLDING COMPANY PROVISIONS HAVE PROMPTED THE DEVELOPMENT AND CAPITALIZATION OF THE INDUSTRY DURING BOTH GOOD AND BAD TIMES. IN ADDITION, IT HAS BEEN A VALUABLE TOOL FOR THE FSLIC IN SOLVING THE PROBLEMS OF FINANCIALLY TROUBLED INSTITUTIONS. IF, HOWEVER, CONGRESS FEELS IT IS NECESSARY THAT THE NATIONAL HOUSING ACT BE AMENDED, NASS&LS WOULD BE OPPOSED TO ANY PROVISION WHICH DOES NOT GRANDFATHER EXISTING HOLDING COMPANIES AND THE ACTIVITIES IN WHICH THEY ARE PRESENTLY ENGAGED.

PRIVATE DEPOSIT INSURANCE OR GUARANTEE

NASS&LS HAS HISTORICALLY SUPPORTED THE RIGHT OF THE VARIOUS STATES TO ENACT LEGISLATION WHICH PERMITS STATE-CHARTERED FINANCIAL INSTITUTIONS, BE THEY THRIFT INSTITUTIONS OR CREDIT UNIONS, TO OPERATE UNDER A SYSTEM WHEREBY FUNDS DEPOSITED IN SUCH INSTITUTIONS ARE PRIVATELY INSURED OR GUARANTEED. IN LIGHT OF THE PROBLEMS RECENTLY ENCOUNTERED BY SEVERAL PRIVATE INSURANCE FUNDS, NASS&LS STRONGLY URGES CONGRESS AND THE FEDERAL REGULATORS TO FACILITATE THE CONVERSION TO FSLIC INSURANCE OF ANY STATE-CHARTERED NON FSLIC-INSURED THRIFT INSTITUTION WHICH DESIRES TO CONVERT.

CONCLUSION

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE, THE NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS IS IN TOTAL AGREEMENT WITH THE CONCEPT THAT THE THRIFT INDUSTRY MUST BE A BETTER CAPITALIZED, BETTER SUPERVISED

INDUSTRY WITH A VIABLE INSURANCE FUND. WE BELIEVE THAT THESE ENDS CAN BE ACCOMPLISHED THROUGH PROPER SUPERVISION BOTH ON THE STATE AND FEDERAL LEVEL AND THE ORDERLY INCREASE IN THE NET WORTH OF THE THRIFT INDUSTRY. WE FEEL, HOWEVER, THAT THE IMPOSITION OF HARSH AND SOMETIMES INFLEXIBLE REGULATIONS SHOULD BE REPLACED BY PROPER SUPERVISION EXERCISED BY QUALITY REGULATORS DOING THE JOB THEY WERE EMPLOYED TO DO.

THANK YOU FOR THIS OPPORTUNITY TO EXPRESS NASS&LS' POSITION ON THE RAPIDLY CHANGING FINANCIAL SERVICES INDUSTRY. WE LOOK FORWARD TO WORKING IN HARMONY WITH YOU AND YOUR STAFF AS YOU ENDEAVOR TO CRAFT AN APPROPRIATE LEGISLATIVE RESPONSE TO DEAL WITH THIS COMPLEX ISSUE. I LOOK FORWARD TO RESPONDING TO ANY QUESTIONS WHICH YOU MIGHT HAVE CONCERNING NASS&LS' POSITION.

The CHAIRMAN. Thank you, Mr. Bergman.

Gentlemen, I think you know how I feel about the right of State legislatures to make decisions for State-chartered institutions, be they banks or savings and loans, as long as it is within their own boundaries. That was the spirit in which I offered the closure of the South Dakota loophole and certainly I would agree with Mr. Bailey. I fought vigorously on the floor, as well as in the committee, for Senator Dodd's proposal to go further than that. Although I disagree, I have learned to count and he has more votes than I do on that particular issue. So I can voice my disapproval and vote with the minority on that particular issue.

So my record is clear on States rights and so to get to the issue we were discussing this morning with Ed Gray, it's not my place or my desire to dictate either to banks or to savings and loans what State legislatures should do within their State boundaries. If my State legislature wants to grant powers to State-chartered institutions that I would not approve of on the Federal level, fine; that's their business. I wouldn't go out and try to persuade them otherwise.

CONGRESS SHOULD PROVIDE CONFIDENCE TO REGULATIONS

But I think Mr. Gray makes a very good point as far as the insurance fund is concerned. I've got another responsibility and that is to do everything I can in this committee to provide for the safety and soundness of institutions and provide the credibility and confidence in both the FDIC and the FSLIC.

So how do we rationalize that problem? First of all, it's up to the State legislature to decide what to do, but if they are under the umbrella of the FSLIC which gives their customers a great deal more confidence and ability to work and function within their State, how do we solve that problem? Like I say, nobody is more strongly for States rights than I, but I also don't think that it's fair to allow those State-chartered institutions that may be getting into a so-called go-go category that has been referred to of operations, to have the advantage of that Federal insurance, and yet, taking some very risky business opportunities that help endanger that fund.

Is risk-related insurance the way to go? How do you resolve that difference? Both of you are here advocating leave us alone. When you've got that Federal insurance, how are we going to protect that fund and leave you alone at the same time?

Mr. BERGMAN. Mr. Chairman, I think it would be helpful if we set the State system in perspective with a little bit of the history about State-chartered institution. Today, as it has been for many years, it is more expensive to be State chartered and federally insured institution than it is to be a federally chartered and federally insured institution. Therefore, it is incumbent upon State legislatures and State regulators to offset that cost by additional asset authority.

Clearly, expanded assets powers has got to be the balance that must be maintained if we're going to have a dual system.

Historically managers of many institutions maintained their State charter because their grandfathers who ran the institution liked it that way. "We have always been State chartered," they

used to say. But when the crunch came in the late 1970's and early 1980's, most savings and loan executives had to take a look at what made good business sense for their institutions, for their stockholders if they were stock institutions or for their shareholders if they were a mutual institution. In doing so, they took a look at Garn-St Germain and we saw in California and other places a massive changing of charters from the State system to the more liberal Federal system.

What has happened since then is an effort led in large measure by our organization to catch up with Garn-St Germain and to modernize State laws around the country.

The presumption by Mr. Gray that additional authority granted on the investment side is going to in some way be faulty or that the business decisions made by America's savings and loan executives are somewhat less than prudent is still to be proven. Chairman Gray talks about investments in wind farms and he talks about fast food restaurants, of which there is one each out of the 3,300 institutions in the country. What he doesn't tell you is that our organization strongly supports the thrifts and strongly believes that there needs to be a commitment to housing but, at the same time, we recognize that in today's volatile interest rate period those portfolios have got to be expanded. One of the ways we can do that is by making successful investments, using a small percentage of the total assets of the institutions into other areas so that they can ride the wave, if you will, of escalating interest rates. It seems to me that's where we're trying to get the balance back into the dual system and I am disturbed that Chairman Gray would perceive that those investments are in and of themselves inherently poor or bad management decisions or that they in some way would be detrimental to the depositors of that institution.

Chairman Gray mentioned an institution with which I think we are all familiar in California. That institution has made an investment in a commercial broadcasting company. The facts are, as I understand that situation, that the institution, in a relatively short period of time, made \$50 million which went right to the bottom line of that institution. Two years ago it was under water. Today, it is one of the strongest institutions in the State of California because they were able to make a prudent investment outside of the traditional lending area. They still, however, make significant home loans. They are one of the largest lenders in the southern California area and it seems to me that's the lending that counts.

For Chairman Gray to say, investments in high yield bonds or investment in other areas not traditionally envisioned by the creditors of the Home Owners Loan Act is by its very nature risky and unsafe, is not correct.

The CHAIRMAN. Well, you haven't answered my question. It's a nice answer but you haven't answered my question.

Let's assume that I agree with everything you said and they are all prudent investments and they're fine. We are still dealing with a double standard of what the Federal thrifts can do and what the State-chartered thrifts can do.

My question is: Should they be allowed the same insurance rates when they are doing different functions? They may be prudent but some of the activities you're talking about aren't a matter of judg-

ment, they are simply by their very nature more risky than what depository institutions normally invest in.

Mr. BERGMAN. There's no question about that.

The CHAIRMAN. Let me be very specific and expand it beyond this situation. I'm tending to think we ought to look very seriously at risk-related premiums for all institutions. I cannot buy life insurance for my age group at the same premium as my 27-year-old son and I will guarantee you that my 18-year-old son cannot buy automobile insurance at the same rate that I do. It isn't even close.

Now, I realize some of the problems of assigning risk categories and the implications on perceptions if customers find out. But doesn't it make some sense that, forgetting regulations that you don't like coming out, and interference with States rights, there is some merit in saying, you go ahead and perform those tasks and you can be involved in these services allowed by a State legislature, but if you want FSLIC insurance or FDIC insurance it is going to cost you more for that insurance.

VARIABLE PREMIUM APPROPRIATE

Mr. BERGMAN. I think that's a reasonable statement and it's one our organization believes in. We do believe that a variable premium based on investment decisions is appropriate.

The question is, and the problem we have is who makes the decision about the degree of risk? That's the question we just all have to work together on. The sense of what you have said is correct. If you're going to take advantage of broadened investment authority and it will place your depositors' money at risk, then you should be willing to pay a higher premium.

The CHAIRMAN. Mr. Bailey, would you agree with that?

Mr. BAILEY. Mostly, yes. I may be a little out of my element here because I came prepared to talk about savings and loan regulation.

The CHAIRMAN. I understand what you're saying, FDIC.

Mr. BAILEY. Risk-related insurance premiums makes all the sense in the world to me. I agree with you. If I had to pay the same rate for automobile insurance that the high-risk driver has to pay, I probably wouldn't drive very much. I wish I could buy life insurance at the same rate the 18-year-old can. Of course, I can't. Therefore, it seems to me that any time you insure a risk, a premium should be related to the degree of that risk.

The snag is in who assesses the risk and by what standards? I don't know that I'm too comfortable leaving that to a Federal regulatory agency, any more than I am comfortable with leaving to a Federal regulatory agency the assignment of levels of life insurance premiums. There ought to be a better way to do that. If it can be done, then it should be done, but it's very, very difficult to do that.

Both the deposit insurance agencies, the FSLIC and the FDIC, have an ultimate solution to the problem and quite simply it might be painful. Both can simply deny the insurance or revoke it if certain perceived failures of risk are exceeded and that would be politically painful, no question, and that would impose the ultimate discipline on management. The Board could direct the insured institution to do this or that or measure up to some standards of

soundness—safety and soundness—that's what that's all about—or you're not insured past a certain point. Who sets those standards is the question, if the insurability of the institution depend upon it. I think State legislatures and the State regulators can perhaps assess risks on a more realistic basis than a Federal agency can because they are closer to the problem. They are closer to the economy. They are closer to the conditions that affect risk. If there is a clear-cut understanding at the outset that risk will affect insurability, I don't think some of the horror stories that are reported in the press would occur.

The CHAIRMAN. Well, I can't minimize the problem in deciding exactly how those risk categories would be resolved, but I do think it's an area we should pursue. Obviously, you're going to make some errors. Senator Gorton and I feel we are treated unfairly in our age category because we happen to run every morning and think we're in better shape than some of our fat colleagues of our same age and, therefore, shouldn't be given a premium just because we happen to be the same age. So, obviously, there's going to be some disparities in those categories. But I just can't believe that we can't solve it and I think we have to at least have some very serious hearings and look at how we would devise a risk-related insurance premium.

Senator Gorton.

Senator GORTON. Mr. Bergman, on page 7 of your statement you say, "Diversified investment authority is critical to the long-term viability of the thrift industry." The Federal Reserve Bank of Atlanta, incidentally, reported late last year that a few S&L's were diversified in consumer lending but almost none into commercial lending.

Do you mean that institutions that don't exploit these opportunities are not viable and won't remain viable?

Mr. BERGMAN. I believe that if they do not exploit some of these opportunities they will not be viable in the future. I think that the bloom is off the bush, to use an old Western phrase, in terms of the home mortgage, and I think that lending on mortgages has got to be balanced off by other kinds of investments.

Senator GORTON. So they're going to have to change, expand and diversify?

Mr. BERGMAN. That's right.

Senator GORTON. OK. On page 12 you say that you see no need to restrain the powers of savings and loan holding companies. Yet you also repeatedly urge the restriction of benefits enjoyed by thrifts, presumably meaning access to Bank Board advances and the like to institutions which are traditional financiers of home mortgages. Is that not somewhat inconsistent?

Mr. BERGMAN. I don't really see an inconsistency there. It seems to me that when you take a savings and loan holding company, and you have it regulated by the Federal Home Loan Bank Board as opposed to another agency, you are at least within the family of thrifts that the holding company was originally set up to involve itself.

If you get off into some of these other areas you're liable to get beyond yourself in terms of the regulatory structure and cause further conflict within the whole system.

Senator GORTON. Can I properly summarize your testimony and your answers to Senator Garn as being cautiously in agreement, with some restrictions, to Mr. Gray's proposal about risk-based insurance, but to being vehemently opposed to those portions of his bill which would give the FHLBB greater direct control over State-chartered S&L's?

Mr. BERGMAN. Yes; you may characterize it exactly as that.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gorton.

Gentlemen, I expect there will be some additional questions for your response in writing and we appreciate your testimony very much. Thank you.

The committee is adjourned until tomorrow when we will continue these hearings.

[Whereupon, at 11:40 a.m., the hearing was recessed, to be reconvened at 9 a.m., Wednesday, May 15, 1985.]

[Response to written questions of Senator Garn from Sidney A. Bailey follow:]



OFFICE OF THE EXECUTIVE VICE PRESIDENT AND ECONOMIST

June 28, 1985

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Legislative Counsel

Honorable Jake Garn
United States Senate
Room SD505
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

By this letter I am responding to the questions regarding "changes in the financial services industry" forwarded to CSBS by your letter of June 10, 1985. These responses are submitted on behalf of the Conference of State Bank Supervisors, as an extension of my testimony presented on May 14, 1985.

The questions submitted to me and my responses thereto are as follows:

1. Given that some states may have been excessive in granting new authorities for state chartered institutions and that the federal deposit insurance system bears all of the risk of failures:

a. How would you suggest that the federal government deal with the outliers yet preserve our dual system?

b. Should the federal agencies be permitted to set aggregate and individual limits on each approved activity to maintain federal insurance? If so, what limits would you recommend for each activity?

Response: At the outset, it is important to note that the problem you have outlined, the excessive use of non-traditional powers, is minimal in the banking industry, as distinct from state chartered thrift institutions. This may reflect the relative health and strength in market position enjoyed by banks or it may be a result of bankers and bank supervisors being more cautious in their approach to new powers. Broad grants of authority by state legislatures do not automatically translate into excessive use of non-traditional powers.

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A key to the problem is the ability of the primary regulator to use rules and regulations to ensure a balance between risk and the industry's need to be competitive and profitable. In California, for example, enabling regulations act as such a balance wheel.

I believe that agencies administering the federal deposit insurance system should have available two tools to deal with the excessive use of non-traditional powers: risk-related premiums and the right to refuse to insure deposits held at a particular institution. As I stated during my testimony, "risk-related insurance premiums makes all the sense in the world to me." Any time that you insure a risk, the premium paid should be related to the degree of that risk. Since we are dealing with the problem of risk entailed by the excessive use of non-traditional powers, the approach which would seem most logical would be to provide a basic premium, with a surcharge levied based upon the percentage of assets in non-traditional activities which are considered more risky than traditional banking activities.

The difficulty is, who should assess the degree of risk involved in a particular activity and by what standards. An activity which is risky in California may be perfectly safe and profitable in Virginia. In point of fact, an activity which is risky in Blacksburg, Virginia, may be perfectly safe and profitable in Alexandria, Virginia. Moreover, an activity which is risky in Alexandria if performed by Banker X may be perfectly safe and profitable in Alexandria if performed by Banker A. Risk assessment requires a knowledge of the activity, the market and the people involved. The extent to which a federal regulator or a state regulator, an insurer or a primary regulator, can best make those judgments is a critical question in setting up a system of risk assessment. Perhaps, like the medical profession, we should look to a standard of local practice. As I have suggested, I believe that state regulators are closer to the problem, the local economy, and generally to the conditions that affect risk.

Both the federal deposit insurance agencies, the FSLIC and the FDIC, have a solution to the problem at their disposal. Although it might be painful, both can simply deny insurance or revoke it if perceived standards of risk are exceeded. To soften the political pain, it might be possible to simply refuse to insure any new

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accounts opened with an institution or to refuse to insure the deposits at an institution past a certain point or amount. If individual institutions are given a compliance period during which they must reduce portfolio risk or risk losing their insurance or having it limited, this would almost certainly produce the desired result of reduced risk-taking.

The right to determine the insurability of a certain institution includes the right to adopt guidelines on insurability and to apply those standards on a case-by-case basis. CSBS has never quarrelled with this approach. On the other hand, we are very strongly opposed to the expansion of FDIC authority over the activities of banks at the expense of the authority of the primary regulators, both State Banking Departments and the OCC.

On December 13, 1984, the FDIC proposed a rule which would broadly preempt state authority over the activities of state-chartered banks, expanding FDIC jurisdiction at the expense of the primary regulator. CSBS, by a letter dated February 11, 1985, asked that the FDIC withdraw the proposed regulation "because its provisions exceed statutory authority, it has not been justified and it will severely damage the vitality of the dual system." I have attached a copy of the CSBS letter hereto. CSBS believes that federal agencies should not be permitted to set industrywide aggregate and individual limits on approved activities, but may issue guidelines on insurability, including risk factors, to be applied on a case-by-case basis.

2. Some have criticized certain states ability to charter and supervise. Should the Congress adopt the certification procedures established in the Bush Task Force? What modifications, if any, would you suggest?

Response: The vast majority of state banking departments are as well, or better equipped to charter and supervise their institutions than are their federal counterparts. This notwithstanding, it is understandable that federal agencies which rely on state examinations and reports in executing their responsibilities desire a role in quality control exercises or certification procedures.

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CSBS has developed two voluntary programs -- Department Self-Evaluation and State Banking Department Accreditation -- designed to help state regulators preserve the current dual banking system and meet their own, diverse professional and managerial needs. The goals of these programs are to strengthen state banking department capabilities to assure the safety and soundness of banking within each respective state, and to achieve recognition of the high level of capability within the state bank regulatory system.

States considering accreditation first evaluate themselves, using the Self-Evaluation Guide which is contained in the program guide. The approximately 100 criteria of the Self-Evaluation Guide provide a department with a list of those items that other regulators consider essential in maintaining a superior department. If deficiencies in the department are discovered, the Self-Evaluation should produce a standard against which improvement may be measured. When the department has removed its shortcomings, if any, it may decide to request accreditation.

Accreditation entails forwarding to CSBS a completed self-evaluation, together with appropriate narrative and documentary materials. This material is reviewed by a panel of distinguished regulators who then visit the department and perform their own evaluation. The report of this visitation team is reviewed by a second, audit panel to ensure consistency from state to state, and act as a quality control mechanism. If recommendations are favorable, the decision is made by CSBS to accredit for a five year period, subject to annual review and renewal.

No federal agency undergoes a comparable, rigorous standards review. CSBS believes that once a state has completed this review and has been accredited, federal agencies should accept the examination reports and findings of that state unless the agency can show cause why it should not. In essence, the burden of proof of the quality of state supervision would be shifted from the state to the federal agency in accredited states. Of course, the FDIC would continue its presence in the examination and supervision of state-chartered problem banks to the same extent it had such a presence in national banks. It is of note that, in developing its review programs, CSBS invited participation by the federal agencies. That door remains open.

Honorable Jake Garn
June 28, 1985
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To the extent that Congress may feel that a federal agency should pass judgement on the state accreditation program, CSBS believes that the responsible federal agency should be one which has no vested interest in the outcome. For example, under the Bush Task Force proposal, there is an apparent conflict of interest in having the FRB pass judgement on the quality of a state banking department, where approval would mean a withdrawal of the FRB from examination and supervision of Bank Holding Companies in that state. This conflict does not appear to exist with the FDIC, so long as it is able to maintain a presence in troubled institutions.

Very truly yours,

Sidney A. Bailey

Sidney A. Bailey
Commissioner of Financial
Institutions/Commonwealth
of Virginia

SAB : jac

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY PART I

WEDNESDAY, MAY 15, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Hecht, Proxmire, Cranston, Riegle, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning's hearing is a continuation of the oversight hearings we began on May 8, 1985, concerning changes in the financial services industry.

Having completed the testimony of the regulators, we now begin to hear from some of the competitors in the industry. We welcome Mr. Preston of J.P. Morgan; Mr. Telling from Sears; Mr. Shipley from Chemical New York; Mr. Budd of Travelers; Mr. Caspersen from Beneficial; and Mr. McElwee of John Hancock Insurance who I'm told will be here shortly. I certainly wish to thank each of you for taking your time to appear before the Banking Committee today. We had anticipated also hearing from Jim Robinson of American Express and Mr. Scheier from Merrill Lynch but, unfortunately, they could not be here today. We will schedule their testimony for a later date in the very near future.

That leaves just Mr. Telling to represent the securities industry but I'm sure you will be able to do that without any difficulty.

In reading the written testimony I notice that it is becoming extremely and increasingly difficult to distinguish financial conglomerates like some of our witnesses today from institutions regulated like banks. I look forward to hearing your testimony.

Before we do, I'd like to turn to Senator Proxmire to see if he has any opening remarks.

Senator PROXMIRE. I have no opening remarks, Mr. Chairman, but I am really impressed by this marvelous panel with great, great talent. They've done a super job and the taxes they pay are very welcome.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, that almost sounded like an endorsement of a corporate minimum tax.

Senator PROXMIRE. No. I'm talking about the taxes they personally pay.

Senator D'AMATO. Mr. Chairman, I have a statement that I'd like to be included in the record as if read in its entirety.

The CHAIRMAN. Certainly.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I'd like to begin by thanking these distinguished witnesses for taking the time from their busy schedules to participate in the Senate Banking Committee's oversight hearings on the financial services industry, and I would like to welcome two of my constituents: Louis Preston, the chairman of the board of J.P. Morgan & Co. and Walter Shipley, the chairman and chief executive officer of Chemical Bank.

As I examine the current landscape of the financial services industry I see a regulatory framework where all of the traditional lines separating the banks, the thrifts, the insurance underwriters, and the securities industry have blurred.

In today's competitive environment, we see laws restricting interstate banking, and the mixing of commercial banking and investment banking, while at the same time we see nonbank banks, which skirt all of these nonlaw laws. We see major disturbances in our financial system which include: Penn Square, Continental Illinois, Bank of America's mortgage-backed securities writeoff, ESM Government securities, BBS Government securities, and the recent crisis in the thrift industries in Ohio and Maryland. All of these names add up to the most unstable financial system since 1929.

I recognize that a great many of today's problems are a result of interest rate deregulation and of the interest rate roller coaster of the late seventies and early eighties.

However, I am disinclined to think that broad deregulation is the answer to our prayers. When deposit insurance was created in 1933 it was intended that banks would provide stability to our financial system. But it was never contemplated that banks would sustain extensive levels of risk.

As we stand at the crossroads and decide what we want our financial services industry to look like we must consider our actual goals: Restoring stability to the system, benefiting consumers, or simply permitting the industry's players to earn greater profits.

As I see it the answer is not a deposit insurance system of risk based premiums which permits banks to engage in high risk activities. Are we to sacrifice stability in the name of competitive freedom? I for one am deeply concerned with the current conditions of our financial services industry and would hope that we can work toward legislation that will restore order and stability to our financial system.

Let me thank you, Mr. Chairman, for holding these important hearings because we certainly need stability. We've heard of nonbank banks. Now we have nonlaw laws.

The CHAIRMAN. And nonthrift thrifts.

Senator D'AMATO. And nonthrift thrifts. I think what we seek is stability in this quickly changing arena of financial services and of course, Mr. Chairman, I'm delighted that two of my constituents, Lewis Preston, chairman of the board of J.P. Morgan; and Walter Shipley who is chairman and chief executive officer of Chemical Bank, are here. Let me commend you for undertaking these important hearings, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Good morning, Mr. Chairman.

Mr. Chairman, I'm delighted to be here this morning to see this distinguished panel and my old friend, Mr. Ed Telling, the chairman of the board and chief executive officer of Sears in Chicago. We're delighted to have you here. And Mr. Budd, whose company has done such outstanding work in the area of small business, something I am very much conscious of as a member of the Small Business Committee, and I just want to say, Mr. Chairman, I regret I won't be able to stay with you long. We have markups in both the Armed Services and Agriculture Committee meetings this morning, but I'd like to put a statement in the record if the Chair doesn't mind.

The CHAIRMAN. Certainly. It will be included.

STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, we have a very distinguished and diverse set of witnesses before the committee today. Before us today are the chairmen of some of our Nation's most prestigious financial institutions.

I am particularly pleased to see Mr. Edward Telling, the chairman of the board of Sears Roebuck & Co. of Chicago, IL. He is a man who needs no introduction of this committee. The Sears name and reputation is a more eloquent statement of his credentials than anything I could say.

I am also pleased to see Mr. Edward Budd, the chairman and chief executive officer of the Travelers Insurance Co. As you may know, I also serve on the Senate Small Business Committee. By coincidence, I attended a breakfast this morning with representatives of the small business community. Travelers was mentioned repeatedly because of its active, committed small business program. It seems that the company has developed a strong, positive reputation as a small business advocate, a fact I am glad to have this opportunity to acknowledge.

Mr. Telling, Mr. Budd, and the other witnesses this morning are well qualified to talk to this committee about the rapid changes in the financial services industry. Each witness brings a unique perspective to these changes, and each has ideas on how Congress should act in response.

I believe Congress must respond to the changes in the marketplace. The old statutory framework is no longer adequate to cope with today's realities—or tomorrow's. Congress must act, and act quickly. As a first step, we should move to report legislation that addresses the issues in last year's banking bill. Other issues, while no less important, should be handled in separate legislation.

We should be under no illusions. Our current failure to act creates real distortions and skews the competition in the financial services sector. We cannot preserve the past through inaction, and failure to act could create serious problems for the banking industry, and other nondepository institutions as well.

I look forward to the testimony from the witnesses this morning. With their help, and the help of other interested parties, I am confident that we can address financial services issues in a positive way, and move quickly forward on a reasonable and appropriate bill.

The CHAIRMAN. Gentlemen, there are five of you and soon to be six and so I would ask that you summarize your testimony and, of course, we will place your entire statements in the record. Mr. Budd, would you like to begin, please.

**STATEMENT OF EDWARD H. BUDD, CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER, THE TRAVELERS CORP.**

Mr. BUDD. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, my name is Edward H. Budd. I am chairman and chief executive officer of the Travelers Corp. Thank you for this opportunity to appear before you to summarize Travelers views concerning appropriate legislative responses to changes in the financial services industry.

During the past several years you have received testimony from various representatives of the insurance industry. The positions of our insurance and agent trade associations are particularly well stated and worthy of your continued consideration.

I know, too, that your committee is aware of concerns among insurance agents—and other representatives of small business in America—about the effect of concentrations of power in our financial institutions on their businesses. We have firsthand experience with those concerns since our independent agents generally don't place all their business with us.

So, to conserve the committee's time, I will not restate points which are familiar to you.

My testimony today concentrates on other events since Congress' last deliberations. The issue I raise is whether these recent events call for change in the Senate's support for legislation precluding bank holding companies from engaging in prohibited insurance activities through State bank subsidiaries.

Travelers is playing a major role in today's changing financial services industry. We support strong competition which stimulates us to develop and deliver to the consumer quality products at the lowest possible cost.

LEADER IN NEW FINANCIAL PRODUCTS

We have been a leader in providing new financial products as we have responded to changing consumer preferences, agents needs, and market demands. A significant illustration of that responsiveness is in our life, health, and financial services businesses, where nearly 90 percent of our premium volume comes from products that didn't exist 3 years ago.

One important challenge as we compete aggressively in this competitive market, and introduce new products, is to anticipate and manage risks associated with each new venture. And to balance those risks against the uncertainties in our existing businesses.

I can testify to the complexities of this responsibility. It's not an academic exercise. We know all too well the problems that have emerged in all segments of the financial services industry. Problems of insurance, securities firms, and among insurance brokers, banks and thrift institutions. And, furthermore, we know that these problems are jarring public confidence and trust in our financial institutions.

We could say that the events of the past few years are isolated management failures. But some regulators responsible for various segments of financial services are concerned—concerned to the point where they pressed for industrywide compliance with increased capital requirements.

We need to think seriously about how these risks compound when we create institutions both large and small, comprised of diverse financial businesses. The result is a complicated multiplication of risks and, therefore, added management and regulatory challenges.

Let me give you examples from my own company of risks taking in multiple businesses. In discussing our potential relationship with a securities firm, an early question was whether annuity contracts issued by another insurer, and marketed by the securities firm, could be reinsured by Travelers. There are also arrangements where Travelers and other insurers issue surety bonds to guarantee payment of commercial paper sold to purchase a portion of a commercial bank's loan portfolio.

Arrangements like these may be simple in comparison to current multiple financial services arrangements. But they caused us to step back to evaluate where risk and leverage really fall.

Most of all, these issues lead us to question whether a regulator of one or more so-called separate businesses could identify true risk factors when financial services are integrated in one institution under a holding company structure.

In this connection, you have considered whether separating various segment of a holding company into their regulated components provides adequate protection for safety and soundness. I submit to you that under these circumstances risks are compounded. And I would question whether the use of distinct subsidiaries would in fact insulate one segment from the problems of another. Our experience with the Baldwin-United situation certainly validates this concern.

Clearly these questions about aggregation of risk go beyond consumer protection. As important as that is, failures of financial institutions over the last 2 years have had a serious ripple effect in capital markets around the world.

Fortunately, these concerns are being addressed in various sectors. I recently participated with other insurance industry representatives and State insurance commissioners in an effort to improve surveillance and examination systems. Progress is being made due to the diligence of the State insurance departments and the National Association of Insurance Commissioners.

We believe there will be similar progress in other segments of the financial services industry. But progress will not come quickly. For these reasons, Mr. Chairman, I question whether this is the time in financial services for fundamental change—change which would further aggregate risk.

In the last session of Congress your committee reported legislation which was adopted by the Senate. One concern addressed in that legislation was whether State legislative action should be allowed to determine the powers of bank holding companies. Given the demonstrated role which the Federal Government plays in maintaining the safety and soundness of the banking system, we feel even stronger now that the ultimate resolution of these questions should be decided at the Federal level.

We do not believe that individual States should have the power to authorize the multiplication of financial services within a bank holding company, and, thereby, compound regulatory complexities and risks to the safety and soundness of our system. Certain recent events would validate the wisdom of your action last year.

Mr. Chairman, I do not represent a point of view that is adverse to change or that urges endless study of issues. I recognize others have differing points of view on these issues. But the events of the last few years have brought me to the sincere conclusion that until the full implications of steps toward integration of financial services are analyzed, and the backup systems put into place, we believe the cautions signaled by financial failures should be recognized before major legislative actions proceed.

Thank you, Mr. Chairman. We would be pleased to aid in your continuing committee deliberations in any way that we can.

[The complete prepared statement follows:]

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STATEMENT

OF

EDWARD H. BUDD

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

OF

THE TRAVELERS CORPORATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

May 15, 1985

Mr. Chairman:

My name is Edward H. Budd. I am Chairman and Chief Executive Officer of The Travelers Corporation. Thank you for this opportunity to appear before you to provide Travelers views concerning appropriate legislative responses to changes in the financial services industry.

During the past several years you have received testimony from various representatives of the insurance industry. In the main we find their positions, particularly those of our insurance and agent trade associations, to be well stated and worthy of your continued consideration. I will not this morning restate all the individual points which have been made since they are familiar to you. Our general agreement with the industry is based both on our long history as an insurer and experiences we have gained as we have broadened our base of products and services.

Your Committee is also aware of concerns of agents with concentrations of economic power. Those arguments have been well-stated. I would only add that this point of view extends not only to banks but to the relationships of independent agents with their insurance companies as well. Independent agents are reluctant to tie their economic security to one insurance company.

My testimony will concentrate on whether events which have transpired since the deliberations of the last Congress would call for change in the Senate's support for legislation precluding Bank Holding Companies from engaging in prohibited insurance activities through state bank subsidiaries.

As you know, the pace of change in financial services continues to accelerate. Constant change is to be expected and welcomed in a free competitive market economy. It seems clear that the changes and innovations which are taking place are benefiting many consumers. At the same time some consumers have been adversely affected by failures in our financial system.

We at the Travelers are part of the changes taking place in our industry and support the strong competition which stimulates us all to deliver to the consumer quality products at the lowest possible cost. The Travelers has a long record of innovation which continues in the current environment. For example, in 1984, nearly 90 percent of our Individual Life, Health and Financial Services volume came from products developed during the last three years.

Travelers is a large financial services organization with over \$36 billion in assets and \$13 billion in revenues. While our primary business is insurance, we have significant involvement in other areas of financial services as well.

We are heavily involved in providing services to large corporations. At the same time our company has a strong base for services to small businesses and individual consumers. In this market we operate through independent small business agents who provide insurance and financial counseling.

We also have operations which market to consumers through cooperative efforts with associations, employers, banks and credit unions.

To respond to the changing requirements of our customers and distribution systems, we have augmented our insurance services to the point where we offer a broad array of financial products and services including:

- * Mutual funds
- * Securities clearance and execution
- * Mortgage banking
- * Personal trust services
- * Fee for service arrangements, and;
- * Foreign and domestic investment management

Since 1969 we have owned The Massachusetts Company, one of the oldest corporate fiduciaries in the country. As part of our contingency planning, we have activated MassCo's long-standing

powers under Massachusetts' law to do a banking business and have obtained FDIC Insurance.

We have also developed a package of cash management services which brings together the availability of all of our normal insurance and pension fund products and mutual funds together with a charge card, line of credit and a transaction account. The transaction account is provided as part of our package through a contractual arrangement with a commercial bank.

Our approach to innovation and expansion in products and services has been evolutionary. We have added products and services incrementally rather than undertake major acquisitions.

One of the challenges as we move our company forward is to anticipate and manage the risks associated with new ventures, as we also balance these risks with the risks of our existing business. This is not an academic exercise as testified to by recent events in the financial services industry. These events point to the need for some caution as one considers further integration.

As we know too well, problems have emerged in all segments of the financial services industry including insurance companies, securities firms, insurance brokers, banks and thrift institutions. It is these problems which have resulted in what I

think we would all agree is a jarring of public confidence in financial institutions.

A case can be made that the events of the last few years are isolated instances of management failure. However, the regulatory officials responsible for the various segments of financial services have expressed concern and indeed have pressed for industry-wide compliance with increased capital requirements. In this context we must consider how the risks of compounding the current difficulties by the creation of institutions large and small with more diverse businesses multiplies the management and regulatory challenges.

Let me give you examples from my own Company in risk taking in multiple businesses. In discussing the synergies of a potential relationship with a securities firm, an early question was whether annuity contracts issued by another insurer and marketed by the securities firm could be reinsured by Travelers. In another situation there are arrangements where Travelers and other insurers issue surety bonds to guarantee payment of commercial paper sold to purchase a portion of a commercial bank's loan portfolio.

These arrangements, perhaps simple in comparison to many multiple financial services company arrangements currently in use, have caused us to step back to evaluate where the risk and leverage really fall. The related question is would a regulator of one or

more of the affected businesses be able to identify the true risk factors. For example, we do know that regulators are appropriately concerned with the creation of off balance sheet guarantees and contingent liabilities relating to insurance companies and banks.

In this connection, you have considered whether for sound public policy purposes the separation of various segments of a holding company into their regulated components provides adequate protection for safety and soundness. One would have to question whether, if risk is increased through combinations of business organizations, the use of distinct subsidiaries will insulate one segment from the problems of another. Our experience with the Baldwin-United situation would certainly validate this concern.

One point of view is expressed by the Federal Reserve Bank of Minneapolis in its Annual Report of 1982:

"...experience suggests rather clearly that in times of peril it may not be possible to insulate the bank from the problems of its sister organizations -- even when such problems arise in affiliated organizations, including subsidiaries of bank holding companies."

This point of view would, we feel, be equally applicable to the insurance or securities business components of a diversified organization.

Federal concerns with the question of aggregation of risk become particularly acute when dealing with the safety and soundness and public confidence in the financial services industry. Clearly these concerns legitimately go beyond consumer protection, since failures of financial institutions over the last two years have had a ripple effect felt in the capital markets around the world.

Mr. Chairman, I know that the strains on the system and the individual incidents affecting each segment of the financial services industry trouble you and members of this Committee. This Committee is concerned with whether appropriate mechanisms are in place to protect consumers from individual crises and also assure continued trust and confidence in the system.

Fortunately, the issues of safety and soundness of financial systems are being addressed in various sectors. I recently participated with other insurance industry representatives and state Insurance Commissioners in an effort to improve the insurance industry surveillance and examination systems. This was a complicated task but progress is being made due to the diligence of the state insurance departments and the National Association of Insurance Commissioners. And we believe there

will be similar progress in other segments of the financial services industry.

While there has been a lag in regulatory systems adjusting to the changing environment, and indeed lag is inevitable, we have confidence that with improved procedures, information and staffing, the regulatory agencies of each of the sectors will be equal to the task. But this task will not be accomplished quickly. In light of this fact, we would question whether this is the time for fundamental change in the structure of the financial services industry which would further aggregate risk.

In the last session of Congress your Committee reported legislation which was adopted by the Senate. One concern addressed in that legislation was whether state legislative action should be allowed to determine the powers of bank holding companies. Given the demonstrated role which the federal government plays in maintaining the safety and soundness of the banking system, we feel even stronger now, than we did then, that the ultimate resolution of these questions is a matter to be decided at the federal level. Certainly recent events would validate the wisdom of your action last year.

Thank you, Mr. Chairman. We would be pleased to aid in your continuing Committee deliberations in any way that we can.

The CHAIRMAN. Mr. Preston.

STATEMENT OF LEWIS T. PRESTON, CHAIRMAN OF THE BOARD,
J.P. MORGAN & CO., INC.

[The complete prepared statement follows:]

Thank you for the opportunity to address this committee on a subject critical not only to the financial services industry but to the American economy itself.

Congress faces a major challenge as it grapples with changes in the financial world: how to shape public policy that will serve our best economic interests as a nation and meet the complex needs of consumers of financial services.

Responding to the challenge, this committee last year developed a bill, later approved by the full Senate, that proposed needed reforms in the structure of the financial services industry. The bill addressed a number of issues -- including the status of nonbank banks, regional interstate banking, and added powers for bank holding companies -- that still await Congressional consideration. You have asked me to comment on key issues from the point of view of J.P. Morgan, an international wholesale financial institution. Rather than attempt to touch on all the significant points of interest -- many of which I expect will receive ample attention from others appearing before you -- I will focus on one issue of primary concern: We firmly believe that revision of the Glass-Steagall Act is in the public interest and deserves high public policy priority.

As a nation, our need for capital to support economic growth and to create new industries and jobs is great. A study sponsored by The New York

Stock Exchange at the beginning of this decade concluded that U.S. capital requirements in the 1980s would be enormous, amounting to trillions of dollars, "even for the economy to perform at minimally acceptable levels."¹ The President's Commission on Industrial Competitiveness, in its recent report,² emphasized the essential role capital plays in U.S. economic strength:

Capital is the fuel for our economic machine. Invested in productive assets like buildings and machines, capital provides the tools we need to compete. Invested in research and development, it provides the technological advances that are key to competitiveness. Invested in entrepreneurial endeavors, it provides the resources required to bring new ideas to market. The productive and creative use of capital is a strong factor in any nation's competitive position.

The report emphasizes that lower cost of capital represents a major advantage to our competitors. It cites, for example, a study by the Semiconductor Industry Association showing that the Japanese success in semiconductors during the 1970s was due, in large part, to the advantage of low capital costs, not superior technology. As a key stratagem for improving our country's international competitiveness, the Commission recommends that we "increase the supply of capital available for investment, reduce its cost to American business, and improve its ability to flow freely to its most productive uses."

The recognition that efficient capital formation is fundamental to economic growth is, of course, not new. W. Michael Blumenthal, writing in 1978 while Secretary of the Treasury during the Carter Administration, acknowledged the U.S. capital shortage and the need to tackle it to avoid "persistently unsatisfactory productivity increases, rising unit costs, and a continuation of the unemployment which is in large measure a result of these

two factors." He asserted the need to "revaluate the complex of government rules, regulations, and procedures affecting financial intermediaries to ensure that there are not, in our regulatory structure, any factors inhibiting the sustained flow of financing for investment." Mr. Blumenthal also advocated "reevaluating the efficiency with which our public securities markets meet the needs of savers, borrowers, and risk-takers."³

I suggest that the appropriate context for discussion of the structure of the financial industry is this: as a nation, the United States suffers a shortage of capital for needed investment, and available capital is costly. Productivity, industrial competitiveness, jobs, and continued improvement in the quality of life for all of our citizens hinge significantly on the ability of our financial markets to mobilize and allocate extraordinarily large flows of capital efficiently.

With this perspective in mind, the Glass-Steagall Act's constraints on commercial bank participation in certain areas of the securities markets are revealed as more than an anachronism: they are an increasingly serious impediment to capital market efficiency in the United States. Strong evidence suggests that Glass-Steagall's restraint of competition works against both public and private organizations -- from municipal governments to small entrepreneurial businesses to large corporations -- in their efforts to raise capital and finance business activities at the lowest possible cost.

The legislation developed by this committee last year, which would have authorized bank holding company subsidiaries to compete in certain

protected markets -- for municipal revenue bonds, mortgage-related securities, and commercial paper -- was a significant and laudable first step toward the goals of increasing capital market efficiency and strengthening the banking system. But more fundamental revision of the existing order is required.

Benefits of competition

It is an axiom of public policy in the United States that competition promotes the public good by reducing costs and stimulating innovation. Artificial barriers to competition should not be tolerated unless there is strong evidence that an overriding public interest makes such barriers necessary.

The Glass-Steagall Act erected artificial barriers to competition in the securities markets more than half a century ago by limiting commercial bank participation in key areas -- but, significantly, not all areas -- of the securities markets. The result is that today securities firms enjoy the status of a protected class of competitors in some of these markets. I will return later to Congress' reasons for imposing competitive restraints, which we believe to have been mistaken. First, however, let me review the characteristics of the markets protected from competition by the Glass-Steagall Act and contrast them with markets in which investment and commercial banks vie for business.

One standard way to assess the vigor of competition is to examine the market share of the leading firms in an industry. In the U.S. corporate securities market, the major market in which bank affiliates' participation as

underwriters and dealers is restricted, concentration of market share is significant. To take the corporate debt market in 1984 as an example, the top five underwriters managed 75% of the total volume of securities issued in the U.S. that year.

This high level of concentration provides a striking contrast to the market share captured by the leading underwriters in the Euromarket, which is the most open competitive market in the world and in which commercial bank affiliates are highly visible competitors for underwriting business. Again taking the corporate debt sector in 1984 as an example, the top five underwriters in this segment of the Euromarket managed just 49% of the total volume of debt securities issued. That's 75% concentration of market share for the top five firms in the protected U.S. market versus 49% in the more competitive Euromarket.⁴

A similar concentration pattern plagues the U.S. municipal bond markets. As you are aware, Glass-Steagall allows banks to compete as underwriters in the municipal general obligation bond market but through a quirk of history not in most segments of the revenue bond market. In the areas of the municipal revenue bond market where securities firms enjoy a sheltered position, the top 10 underwriters managed 58% of the issues launched in 1984. In the housing and education sectors of the revenue bond market, which Congress opened to bank competition in 1968, the top 10 underwriters in contrast managed only 46% of issues done in 1984. And in the general obligation market, where banks and securities firms have competed for decades, the top 10 underwriters' market share was just 39% in 1984.⁵

Several studies have documented the lower issuing costs enjoyed by municipal borrowers in the general obligation bond market, a result attributable to vigorous competition from banks to underwrite and deal in these bonds. Not surprisingly, the prospect of such savings has encouraged the National Governors Conference and the U.S. Conference of Mayors, among many others, to support measures that would permit banks to underwrite municipal revenue bonds as well.

One of the most disturbing aspects of concentration in the markets from which commercial banks are absent is that regional broker-dealers, which traditionally have served both local investors and local companies in bringing new issues to market and maintaining a secondary market in their securities, are becoming more and more scarce. The number of National Association of Securities Dealers Automated Quotation (NASDAQ) market makers has been cut in half in the past 15 years. In 1983, there were no market makers at all in 14 states, while 10 states had only one or two. The NASD has stated:

It was these local/regional broker-dealers that brought many local businesses public and provided secondary markets for their securities. Their demise will long be felt by those developing companies that will need their services in the future. Steps must be taken, therefore, to encourage and promote the re-emergence of this vital link in our nation's capital-raising system.⁶

In contrast to the depleted ranks of regional broker-dealers, there are many commercial banks with strong regional networks and customer bases that already serve regional and local corporations as lenders and are familiar with their capital requirements. For many of these regional bank holding companies, expansion into underwriting and market-making activities would be a logical product extension, absent Glass-Steagall barriers.

The profitability of the large investment banks dramatically reflects the concentration of market share in these large firms that prevails in the securities industry. According to Securities Industry Association data, over the past five years (1980-1984) the annual rate of return on equity for 10 large investment banks has averaged 26% -- double the 13% earned by the 10 largest bank holding companies. The large investment banks have been consistently more profitable than the securities industry as a whole, and in 1984 earned a return on equity of 17%, while the rest of the industry earned just 3%. Several major investment banks are reported to have earned pretax returns on equity of as much as 100% in recent years.

The statistics on market concentration and profitability I've just reviewed point to significant potential cost savings for issuers if Glass-Steagall barriers to competition are dismantled, allowing commercial bank affiliates -- at present the best qualified potential competitors for securities business -- to enter the markets as underwriters and dealers. Less obvious are two other ways in which users of financial services are likely to benefit from more competitive capital markets.

One is what might be called a ripple effect of Glass-Steagall. As a practical matter, the Act also stifles competition in areas of the U.S. capital markets that technically are open to anyone, because the ability to underwrite and deal in corporate securities is frequently considered a core qualification for advising corporations on related financial matters, such as mergers and acquisitions. As a result, costs for merger-and-acquisition and other corporate finance services are almost certainly higher than they might

be. It is entirely reasonable to assume that more competition would bring such corporate finance fees down.

Finally, the Euromarket has taught us that innovation is one of the most valuable and perhaps least appreciated benefits that flow from the presence of able competitors with no vested interest in maintaining the status quo and with experience in a wide range of financial markets that adds a new dimension to financial problem-solving. The Euromarket -- and, frequently, affiliates of commercial banks -- have been in the vanguard of innovative financing, to the advantage of issuers and investors alike. The extensive use of debt warrants, which can significantly lower a borrower's cost of financing, as well as zero-coupon bonds, equity-linked issues, and delayed rate-setting mechanisms are just a few examples of such innovation. It is worth noting in this regard that the President's 1983 report on The State of Small Business stated that "innovation in the financial service industry will be the most important factor affecting small business in the next few years" and expressed the hope that financial market restructuring would lead to improved access to capital for small companies.⁷

Market reality

We have heard so much about the revolution in financial markets in recent years that the phrase has lost its ability to seize our attention, much less fire our imagination. Yet the phenomenon that phrase seeks to capture is anything but negligible. We are, in fact, in the midst of a huge, historic shift on the part of borrowers toward raising money in the capital markets -- and increasingly in the international capital markets -- rather than borrowing money from banks.

Technological advances have made the world much smaller, and in the process the capital markets have become more efficient. Today there are more buyers and sellers, more liquid markets, more accurate information, and lower distribution costs in world capital markets than ever before. All these factors often make it cheaper to borrow directly from investors by using commercial paper and other debt facilities than to use banks as lending intermediaries. Here in the United States, it is possible to view this evolution in part as a consequence of the success of the securities laws enacted in the 1930s: disclosure of the financial condition of securities issuers has made the public more willing to buy obligations directly, rather than rely extensively on the banking system to employ their savings in lending to American businesses. This process of disintermediation should not be viewed with alarm: it is an inevitable and exciting consequence of progress. And commercial banks could be more valuable contributors to the new financial order if their activities in key areas of the capital markets were not restricted.

As matters stand, however, Glass-Steagall does create some rather thorny problems for commercial banks trying to adapt to the historic change that is transforming our financial markets. To make the need for such adaptation clear, a closer look at shifts in borrower and investor preferences in the financial markets is illuminating.

Historically, banks have been the primary providers of short-term credit to their corporate clients. During the past decade, however, companies increasingly have raised short-term working capital by borrowing directly from

investors in the commercial paper market, bypassing the banks. The commercial paper market today, in fact, has grown to a quarter of a trillion dollars from less than \$50 billion 10 years ago. One reason for this is that reserve requirements frequently have made it impossible for banks to offer short-term loans at competitive rates. The irony of the situation is that, as the law is currently interpreted, commercial banks are forbidden to act as commercial paper dealers for their customers. Instead, investment banks have captured an increasing share of the short-term credit business, which for many years was a mainstay of commercial banks' revenues. Meanwhile, borrowers in recent years also have turned in greater numbers to the capital markets for medium-term financing, which had come to be another important focus of bank lending.

Where artificial barriers to bank participation do not exist -- in the Euromarket, and increasingly in London, Paris, Frankfurt, and Tokyo, as other nations dismantle parochial barriers to competition -- banks have been able to adapt to this extraordinary change by becoming vigorous competitors in the capital markets. The United States provides the glaring exception to this rule. Here, in our home market, U.S. banks are shut out from serving their traditional customers' financing needs by the Glass-Steagall Act. So we find ourselves forbidden to participate in capital market financings done here in the U.S. for multinational corporations with which we have longstanding relationships, and which we serve in the international capital markets. By way of example, I would cite a recent bond issue of \$400 million by Eastman Kodak, sold here in March.⁸ If this company had needed financing in the Euromarket, bank securities affiliates would have been competing for a share in the underwriting.

An exasperating footnote to this state of affairs is that the International Banking Act of 1978 permits more than a dozen foreign commercial banks to engage simultaneously in commercial banking and corporate securities underwriting in the U.S. In the transaction I just mentioned, the U.S. securities affiliates of three foreign banks with large U.S. branches were among the underwriters. It's also worth noting that Credit Suisse, one of the major Swiss banks, owns a substantial interest in First Boston, one of the leading publicly owned investment banks in America -- while at the same time Credit Suisse operates commercial bank branches here in the U.S. We support these banks' involvement in both types of financial activity, but we think it makes no sense for U.S. bank holding companies to be denied the same opportunities.

Meanwhile, as you well know, securities firms here in the U.S. have been setting up limited-service or nonbank banks, in effect gaining access to commercial bank markets without the parent firms' being subject to bank holding company regulation. The list of major firms that have opened or plan to open such institutions includes E.F. Hutton, Merrill Lynch, Drexel Burnham Lambert, Paine Webber, Bear Stearns, and most recently Goldman Sachs. Again, we do not object to their participation in both commercial and investment banking. But access to markets clearly should not be a one-way street. Fairness and common sense demand that all participants in financial markets both enjoy the same opportunities and bear the same responsibilities.

Common objections

Market reality today makes it clear that substantial benefits would

attend the revision of Glass-Steagall. The obvious question: Is there a counterargument so persuasive that it can justify the preservation of Glass-Steagall's competitive barriers in the face of compelling evidence that they are counter to the public interest?

The argument most frequently advanced in opposition to revision of Glass-Steagall is that securities underwriting is too risky for banks. To place this argument in proper context, it's essential to realize that banks have been engaging in securities activities for decades: they are major players in the government securities market; they underwrite and trade in the municipal general obligation bond market (which Glass-Steagall specifically allowed because bank participation was considered integral to market efficiency) and in the housing and education sectors of the municipal revenue bond market (which Congress opened to bank competition for similar reasons in the late 1960s); and bank affiliates underwrite and deal in all types of Euromarket securities. In fact, the separation of commercial from investment banking that Glass-Steagall is popularly supposed to have accomplished was not a real separation at all: it amounted to selective limitations on bank involvement in a few, albeit critical, areas of the securities markets. Securities activities in these areas are similar to those in which banks now engage, and in which they have engaged for years. This selective limitation makes arguments that commercial and investment banking ought to be divorced intellectually indefensible.

No threats to the stability of individual banks or the banking system have arisen from banks' current securities activities; in fact, they have been

notable contributors in most cases to bank revenues. To take a provocative example, one of Continental Illinois' more marketable assets was its London merchant bank subsidiary, which was sold at a premium to book value last year. Far from threatening bank stability, broadening banks' ability to engage in securities activities through affiliates would actually enhance their soundness by providing opportunities to diversify revenues at relatively low risk.

Let me emphasize that the risk involved in underwriting is indeed demonstrably low, contrary to popular perception. There is no evidence that any significant securities firm failure since World War II has been caused by corporate underwriting and dealing activities. (A detailed examination of this question is included in Rethinking Glass-Steagall, a study published by J.P. Morgan in 1984, which is included as Exhibit 2 to this testimony.) It strains the imagination to suggest that underwriting or dealing losses would threaten the existence of a well-capitalized bank securities affiliate, let alone threaten an affiliated bank or the entire banking system.

It is in fact nonsensical to argue that dealing in commercial paper or underwriting an issue of corporate bonds, where the duration of exposure is a matter of hours or days, is riskier than lending money for five or ten years. It's much more logical to argue the opposite: that relatively illiquid loans involving substantial exposure for long periods of time carry greater risk than securities activities.

Let me also say a word about the misperception that deregulation is a

cause of the difficulties some banks have suffered during the past few years. A broad range of credit problems, both international and domestic, have strained the system. In general terms, continuing efforts to wring inflation out of the economy underlie many of these problems. Disinflation -- despite its ultimate importance and value -- can never be anything but traumatic for those who previously had been heavy borrowers. At the same time, imprudent management of lending on the part of some banks has unquestionably contributed to a difficult situation. Without intending to minimize the seriousness of these problems, I must emphasize that they involve traditional banking activities, not new ones. Again, allowing banks to diversify their activities would generate new sources of revenue at relatively low risk and thus actually strengthen the system.

A second frequent objection to abandoning Glass-Steagall restrictions is that separation of commercial and investment banking is necessary to ensure that banks do not exploit conflicts of interest. On this count, it is first of all important to recognize that all business activities involve potential conflicts. Securities firms, for example, face such potential conflicts in their various roles as underwriter, broker, dealer, arbitrageur, and investment adviser. The conflicting interests between the roles securities firms may assume in corporate takeover transactions provide a topical example. In general, forcible separation of such activities is rejected as an unnecessarily drastic remedy that imposes undue economic costs on society; instead, we rely on proper disclosure and regulation to control conflict-of-interest abuse. It is also worth noting that there are significant economic disincentives to exploit potential conflicts, if a firm

wants to maintain its good reputation and continue to attract customers.

That said, existing securities and banking laws provide substantial safeguards against the exploitation of potential conflicts of interest by banks and their securities affiliates. More important still, there is no record of abuses by banks in any of the securities markets in which they are allowed to participate. A 1975 study by the Treasury Department, for example, noted that in all the years that commercial banks had been underwriting municipal offerings, there had been no evidence of any conflict-of-interest abuse.

In most cases, exploitation of conflicts of interest are specifically prohibited by existing law. A bank may not purchase securities from affiliates for its trust accounts, for example. Nor can a bank condition access to credit on the use of other bank services, which would include the services of a securities affiliate. Loans between a bank and its affiliates must be fully secured and are limited in amount. And in the few cases where the law is silent about conflicts of interest, it is precisely because there are strong economic disincentives against exploiting them.

The third frequently cited reason to keep Glass-Steagall is the most difficult to address because, however mistaken, it has become woven into the fabric of our cultural myths. The impression prevails that Glass-Steagall's restriction of bank involvement in underwriting and dealing in corporate securities solved the banking crisis of 1933 and freed the financial world from a malignant source of abuse. The prospect of revising Glass-Steagall

frequently raises the specter of a return to the chaotic conditions of the early 1930s.

This interpretation of events is simply wrong. Contrary to common belief, the problems that existed in the nation's banking structure half a century ago had little if anything to do with banks' securities activities. These problems had their source in the deteriorating economic conditions of the 1930s and the comparatively weak regulatory structure of that time. Depositors' fears, in the absence of deposit insurance, led to runs. Banks were forced to sell assets to meet depositor demand, since liquidity was not supplied by the Federal Reserve. The resulting deflationary cycle led to insolvencies. The measures responsible for restoring the stability of the banking system were the introduction of deposit insurance, the strengthening of the Federal Reserve, and capital infusions provided by the Reconstruction Finance Corporation.

There is no doubt that abuses in the securities markets did exist -- committed by firms that were not affiliated with banks as well as by those that were. Without question, reform of the markets was required. The Securities Act of 1933 and the Securities Exchange Act of 1934 were fashioned by Congress as comprehensive responses to this challenge. These laws and the extensive network of securities regulation that has been developed since then have effectively limited abuses in the securities markets and continue to do so. Bank affiliates that engaged in underwriting securities would be subject to these laws and regulations just as existing securities firms are.

Conclusion

In calling for revision of Glass-Steagall, we are urging that U.S. capital markets be made as vigorously competitive as possible. We live in a capital-short world, and the future capital requirements of American industry -- needed to create jobs and raise living standards -- are huge. It is vital that our markets be able to mobilize and allocate financial resources efficiently.

We seek to contribute to the competitive vigor of U.S. capital markets by underwriting and dealing in the securities markets from which we are barred without good reason. Experience strongly indicates that the entry of bank securities affiliates into those markets would increase competition, reduce the cost of raising capital, broaden access to securities markets, for small firms particularly, and encourage the development of innovative solutions to the financing needs of American business.

Notes to text

1. Building a Better Future: Economic Choices for the 1980s (December 1979: New York Stock Exchange, Office of Economic Research) p. 26.
2. Global Competition: The New Reality. (January 1985: The Report of the President's Commission on Industrial Competitiveness, Volume 1) pp. 2, 25, 27.
3. Capital and Job Formation: Our Nation's 3rd-Century Challenge. Charles D. Kuhner, ed. (1978: Dow Jones-Irwin) p. 312-313.
4. Sources: For U.S. figures, IDD Information Services; for Euromarket figures, Austin-Billinghurst Associates. Figures used give full credit to the manager handling the books. See page 35 of Rethinking Glass-Steagall, Exhibit 2 to this testimony, for prior years.
5. Sources: Public Securities Association and Securities Data Company Municipal databases. Figures used give proportionate credit to co-managers.
6. Small Business Financing: The Current Environment and Suggestions for Improvement (1979: National Association of Securities Dealers) p. 4.
7. The State of Small Business: A Report of the President (March 1983).
8. The announcement of this bond issue is included as Exhibit 1 to this testimony.

THE NEW YORK TIMES, WEDNESDAY, MARCH 27, 1985

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March 27, 1985

Rethinking Glass-Steagall

The case for allowing
bank holding company
subsidiaries to
underwrite and deal in
corporate securities

December 1984

J. P. Morgan & Co. Incorporated

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Introduction

A basic premise of public policy in the United States is that competition promotes the public good by reducing costs and stimulating innovation. Artificial barriers to competition, according to this principle, should be shunned in the absence of evidence that the public interest requires them.

More than fifty years ago, a significant barrier to competition in the U.S. capital markets was erected by the Glass-Steagall Act,^{*} which barred commercial banks and their affiliates from underwriting and dealing in corporate securities. Since passing the Act in 1933, Congress has not thoroughly examined whether Glass-Steagall has served any purpose that outweighs the public interest in promoting competition to achieve economic efficiency.

Fundamental changes in our economy, important shifts in demand for financial services, and the resulting competition among different classes of financial institution in recent years have produced what is aptly termed a revolution in the financial services market. In this environment, competitive inequities inherent in the rigid segmentation of the financial industry provide another compelling reason to rethink Glass-Steagall.

This study analyzes the major issues raised by proposals to allow bank holding company subsidiaries to underwrite and deal in corporate debt and equity securities. It first examines the arguments most commonly made to justify preservation of the artificial barriers to competition imposed by Glass-Steagall and finds these arguments to have little merit. Historical research reveals that the Act did not play a major role in restoring the stability of the banking system; review of the risks and rewards entailed in corporate securities activities shows that permitting bank holding companies to diversify in this way would enhance, not diminish, the system's stability; and analysis suggests that no unmanageable conflicts of interest would arise from the affiliation of banks and securities firms. Finally, the study examines the critical issue of how society would benefit from increased competition in securities markets, which are now significantly concentrated.

The study concludes, and Morgan believes, that there is no valid reason to preserve the securities industry's protected position in U.S. capital markets. Revision of the Glass-Steagall Act, by enabling bank holding companies to adapt to rapidly changing customer demands and competitive realities, would strengthen the banking system—the primary aim of the Banking Act of 1933, of which Glass-Steagall is a part. Most important, revision would promote the development of an efficient financial services industry, with consequent benefits for the American economy.

* Sections 16, 20, 21, and 32 of the Banking Act of 1933 are referred to in this study as the Glass-Steagall Act.

Summary

Examination of the roots and consequences of the Glass-Steagall Act, which largely severed investment from commercial banking, reveals that the Act does not serve the public interest. Bank holding company subsidiaries should be permitted to underwrite and deal in corporate securities for four important reasons:

- More competition in the significantly concentrated securities industry would benefit small and large companies that use investment banking services, as well as individual and institutional investors.
- Permitting bank holding companies to own securities subsidiaries would strengthen these companies and the financial system of which they are a part, by providing opportunities to add new sources of holding company revenue at relatively low risk.
- Potential conflicts of interest that may arise from a bank holding company subsidiary's underwriting and dealing activities can be regulated in the same way that similar potential conflicts in both the banking and securities industries are regulated now.
- Structural defects in the banking system and financial abuses that existed in the 1920s and early 1930s were corrected by the strengthening of the Federal Reserve, the creation of federal deposit insurance, and the regulation of securities markets. The separation of investment from commercial banking was not necessary to achieve or maintain these reforms.

Historical perspective

The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed were associated with commercial banks' securities activities. Careful analysis of the Act reveals that it was too sweeping, however, and that the problems it was meant to solve were addressed more effectively by other legislation.

The securities activities of commercial banks had little, if anything, to do with the collapse of the banking system. The banking crisis was caused by the system's structural defects: there were too many inadequately supervised, poorly managed, and undercapitalized banks. The onset of the depression dealt a devastating blow to smaller banks. Failures among them eventually undermined depositor confidence and put intense pressure on the larger, more stable banks, which were forced to dump their assets on the market to achieve greater liquidity. Inevitably, this drove down the value of their remaining assets. The deflationary cycle, rather than overly risky portfolios or underwriting losses, led to the collapse of the banking system. The establishment of federal deposit insurance and the strengthening of the Federal Reserve were highly effective responses to the conditions that had led to the banking crisis. The Glass-Steagall Act was not.

Abuses in the financial markets did require congressional attention, and they received it when Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. Moreover, the abuses Congress believed were peculiar to commercial banks' securities activities and to their relationships with securities affiliates were addressed by existing law and by other provisions of the Banking Act of 1933 far more effectively than by the Glass-Steagall Act.

Bank safety and soundness

Allowing bank holding companies to expand their securities activities would strengthen these companies by enabling them to diversify revenue sources through profitable activities that carry relatively low risk. In fact, the risk involved in underwriting and dealing in corporate securities—that securities will decline in value during the short period of time that they are held—is no different from the risks entailed in securities activities that banking organizations already pursue in the U.S. government and municipal bond markets and the Euromarket. Corporate securities activities are no riskier than traditional bank lending, which involves credit exposure for a number of years and relatively illiquid assets.

The Securities Industry Association provides convincing evidence of the favorable risk and return characteristics of corporate securities activities in its reports of the profits earned each year by securities firms from underwriting and dealing in both debt and equity securities. Banks have also reported favorable results from underwriting and dealing in U.S. government, municipal, and Eurobond securities, in which they are major market participants. Moreover, no failure or forced merger of a securities firm of significant size during the postwar period has been caused by losses from underwriting or dealing in securities; neither has any bank failed during the period because of its securities activities.

Analysis of all SEC-registered common stock offerings of \$5 million or more since 1976 indicates that they generate substantial net underwriting revenues each year for securities firms. Such analysis also indicates that during the period there were relatively few issues on which underwriters may have sustained actual losses, and that the largest loss indicated for any single underwriter was not large enough, relative to the underwriter's capital base and other revenues, to have had a destabilizing effect.

If, despite the low level of risk involved in securities activities, a bank holding company securities subsidiary did encounter financial difficulties, the effect on a sister bank would be minimal. Any losses incurred by a securities affiliate would not impair the bank's capital because of the affiliate's status as a separately capitalized subsidiary of the holding company rather than the bank. This subsidiary would be obliged to meet the net capital requirements established by the Securities and Exchange Commission. Bank loans to an affiliate would be strictly limited by Section 23A of the Federal Reserve Act. These and other regulatory provisions would insulate a bank effectively from its securities affiliate.

Experience indicates that permitting a bank holding company subsidiary to underwrite and deal in corporate securities would not increase the risk that depositors might lose confidence in an affiliated bank, because the bank's solvency would not be perceived to depend on the fortunes of the securities firm. Furthermore, for the reasons discussed above, a securities affiliate is unlikely to sustain losses that would threaten either its stability or that of its holding company. In addition, any losses it did sustain would be quickly identified and measured, since all securities must be marked to market; thus no uncertainty about the ramifications of any loss would affect market confidence in the parent bank holding company, much less in an affiliated bank.

Conflicts of interest

An effective and economically sound approach to controlling conflicts of interest—based on disclosure, regulation, and judicial remedies rather than on the separation of activities that might cause such conflicts—has been developed under the U.S. securities laws. Moreover, economic incentives to maintain the good will of clients are strong and significantly limit the exploitation of conflicts of interest in any business. Analysis indicates that affiliation between a bank and a securities firm would not present conflicts of interest greater than or substantially different from those now faced by either entity individually, and that the existing regulatory framework would deal effectively with these potential conflicts. There is no need to prohibit bank affiliates from underwriting and dealing in corporate securities because of such potential conflicts.

No inherent conflict exists between banking and promotional activities, including those associated with underwriting and dealing. Banks, like other financial institutions, sell a variety of financial products and services. Federal securities laws and regulations effectively control the potential conflicts that exist when a firm both sells securities and provides investment advice to customers.

The concern that banks might purchase for their trust accounts securities underwritten or dealt in by their affiliates ignores the clear legal and moral duty of a trustee to refrain from self-dealing. This potential conflict is no different from that faced by securities firms that provide fiduciary and investment advisory services and engage in underwriting and dealing activities. Moreover, banks have long faced this potential conflict in their municipal securities activities with no evidence of abuse.

The securities laws effectively control the potential abuse that could occur if a bank securities affiliate underwrote securities of a financially unsound company to obtain repayment of bank loans. The securities affiliate would be subject to civil and possibly criminal liability under the federal securities laws if it failed to disclose all material facts about the financial condition of the issuer and the use of proceeds of the offering.

If a bank made imprudent loans to customers for the purchase of securities underwritten by its affiliate, the bank would jeopardize its own assets so that its affiliate could earn a small fraction of the value of those assets on the sale of securities. The possibility of such imprudent lending was considered and rejected as "not be[ing] rational" by the Federal Reserve Board in its recent order approving a holding company acquisition of a discount securities broker, and would be equally irrational if the securities affiliate acted as principal rather than agent.

Similarly without merit is the concern that a bank would make unsound loans to a company because the securities of that company had been previously underwritten by an affiliate of the bank. A bank would have no economic incentive to make such loans.

Competitive Impact

The Glass-Steagall Act bars a major class of qualified competitors—bank holding company subsidiaries—from participating in U.S. corporate underwriting and dealing markets despite significant concentration in those markets, high securities industry profits, and limited availability of underwriting and market-making services for small business enterprises. There is no public policy reason to preserve the securities industry's protected position in these markets. Removal of Glass-Steagall's barriers to competition would significantly improve capital-market efficiency in the U.S.

The number of competitors in both national and regional markets has declined during the past 20 years, and there is evidence of a trend toward increased concentration that has accelerated since the promulgation of SEC Rule 415 in mid-1982. A small number of national firms control the underwriting and large-block-transaction dealing markets for major corporations, while a decreasing number of regional firms serve smaller companies as underwriters and market-makers. Data indicate that the investment banking firms that engage in corporate underwriting and dealing report very high profits and that concentration levels and costs to issuers and investors are higher in these markets than in comparable markets in which commercial banks compete. In addition, because underwriting and dealing expertise is often considered a qualification for advising corporations on related financial matters, such as mergers and acquisitions, Glass-Steagall restrictions also stifle competition in areas of the capital markets that technically are open to all competitors.

Major bank holding companies have the resources and skill to create securities subsidiaries that could compete with the leading national firms both for the underwriting business of major corporations and as dealers in large block transactions. Smaller bank holding companies could both participate in underwriting the securities of large companies and extend existing relationships to provide underwriting and market-making services to smaller and emerging corporations. The addition of new competitors would be likely to lead to reduced concentration, lower costs, increased innovation, and improved liquidity in those markets.

Competition from bank holding company affiliates would not produce increased concentration or other anticompetitive consequences. Lending markets are less concentrated than corporate underwriting and dealing markets, and banks do not dominate markets in which they now compete with securities firms. Bank securities affiliates would not possess any inherent advantages that would enable them to become dominant competitors, and there is no evidence to support suggestions that commercial banks would engage in illegal or anticompetitive practices in order to gain unfair advantage for their securities affiliates.

Historical perspective on the Glass-Steagall Act

Congress passed the Banking Act of 1933 in response to the collapse of the banking system early that year. Legislators designed the Act to restore public confidence in the system and to protect depositors by insuring the stability of commercial banks. In establishing federal deposit insurance and expanding the powers of the Federal Reserve Board, the Act remedied basic flaws in the structure of the banking system. The Act also included provisions that substantially separated commercial banking from investment banking, the benefits of which have proved dubious. These divorce provisions today are commonly referred to as the Glass-Steagall Act.

Structural defects in the banking system and abuses in the financial markets obviously required congressional attention in 1933. In view of the economic crisis confronting the nation and the public hostility toward the financial community engendered by the stock market crash, the banking collapse, and disclosures of questionable financial practices, it is not surprising that Congress was receptive to sweeping financial reform. Indeed, many of the measures introduced at the time—the creation of federal deposit insurance, for example—have had enduring positive effects.

In banishing commercial banks from the corporate underwriting and dealing markets, however, the Glass-Steagall Act imposed unduly broad restrictions. Its provisions, based on a theory of sound banking practice that Senator Carter Glass had championed for years, won support because of unproved assumptions about the roots of the banking crisis—specifically, that commercial banks' securities activities were an important cause of the banking system's failure. We know now that such activities had little, if anything, to do with the banking crisis. Structural flaws—poor capitalization and inadequate supervision, in addition to external economic factors—led to the breakdown. While certain provisions of the Banking Act of 1933 addressed these problems, the divorce provisions did not.

Finally, it is important to recognize that the securities laws enacted in 1933 and 1934 addressed the problems that had developed in the marketing and trading of securities—problems that were not limited, of course, to commercial banks' securities activities. These statutes supplied the foundation for a regulatory structure that has proved extremely effective to this day in controlling abuses in the securities markets.

The political background

Senator Carter Glass—the principal force behind the adoption of the Glass-Steagall Act—approached the banking crisis that developed in the early 1930s with a predisposition toward a radical, structural solution. He believed that commercial and investment banking were inherently incompatible and that commercial banks should confine themselves to making short-term, self-liquidating loans to finance commercial transactions.¹ As commercial banks and their affiliates became increasingly active in the securities markets during the first three decades of this century, Senator Glass became more and more concerned with what he regarded as a departure from principles of sound banking practice. He

1 See, e.g., U.S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, A-12-A-15 (1975); Perkins, "The Divorce of Commercial and Investment Banking: A History," 88 *Banking L. J.* 483, 490-505 (1971). The theoretical basis of Glass' views was the "real bills" doctrine. This doctrine held that if banks made only short-term, self-liquidating loans to finance commercial transactions "the expansion of bank money [would] be in proportion to any extension in trade that [might] take place or to 'the needs of trade,' and that, when trade contract[ed], bank loans would be correspondingly paid off." L. Mints, *A History of Banking Theory*, 9 (1945). A closely associated doctrine held that "if only commercial loans [were] made, the currency [would] have a desirable elasticity and the banks [would] at all times be in a liquid position." *Id.* Although this theory enjoyed some influence during the early stages of federal banking regulation in the nineteenth century, it never had much influence at the state level, at least with respect to the desirability of enforcing a separation of commercial and investment banking. Moreover, by the early 1900s the barrier between commercial and investment banking had eroded at the federal level as well, marking a decline in the influence of the theory in this regard.

was critical of the McFadden Act, adopted in 1927, which confirmed national banks' authority to underwrite certain investment securities. Later, he observed:

"[W]hen we have had occasion to propose modifications of either the Federal reserve act or the national banking act it has seemed to me that instead of creating a national standard of sound banking which the State systems might be induced to follow, we have introduced into the national banking system some, if not many, of the abuses of the State systems, in order to enable national banks to compete with State banks."²

At the Brokers' Loans Hearings in 1928 Glass expressed concern over the volume of commercial banks' loans to brokers. He stated that the proponents of the Federal Reserve Act, of which he had been a principal architect, thought "we should have a system that would meet the requirements of legitimate industry and commerce, and not a system that would lend itself to what many of us regard as an unproductive operation of stock and commodity gambling."³ In short, Glass thought that commercial banks' securities activities were inconsistent with sound banking practice.

Congress' consideration of Glass-Steagall

The stock market crash in October 1929 provided the initial impetus for Glass' efforts to make commercial banking practice conform with his theories. In May 1930 the Senate approved S. Res. 71, which authorized the Senate Committee on Banking and Currency "to make a complete survey" of the national and Federal Reserve banking systems, with particular attention to banks' involvement in speculative securities activities through investments, through the extension of credit to support such activities, and through the formation of "investment and securities trusts."⁴ One month later, Senator Glass introduced a bill that included certain provisions to which the origins of the Glass-Steagall Act can be traced. Although the relevant provisions in this package of reforms bore little resemblance to the legislation that ultimately became the Glass-Steagall Act, the bill did contain a provision somewhat similar to section 16 of the Act, which prohibits banks from underwriting or dealing in corporate securities.⁵ The bill also provided for the regulation of affiliates by requiring member banks to file reports on each of their affiliates with the federal regulatory authorities. The term "affiliate" was defined broadly to include, among other things, a "finance company, securities company, investment trust, or other similar institution" controlled directly or indirectly by a bank "or by the shareholders thereof who own or control a majority of the stock of such bank."⁶

No immediate action was taken in response to the passage of S. Res. 71 or to the introduction of Glass' bill. In late 1930, however, an increase in the rate of bank failures provided further impetus for congressional action in the banking field. Of the 1,350 banks that failed in 1930, more than 600 of them failed in November and December of that year. Moreover, the failure of the Bank of United States in December shook the confidence of depositors. The failure not only was the largest in history at that time, but also involved a bank whose name caused many people to think it had a special, official status.

2 *Operation of the National and Federal Reserve Banking Systems: Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 71st Cong., 3d Sess. 14 (1931) (statement of Sen. Glass) [hereinafter S. Res. 71 Hearings].

3 *Brokers' Loans, Hearings Before the Senate Comm. on Banking and Currency on S. Res. 113*, 70th Cong., 1st Sess. 53 (1928) (statement of Sen. Glass).

4 See 72 Cong. Rec. 8335 (daily ed. May 5, 1930) (Senate approves S. Res. 71). S. Res. 71 had been reported to the full Senate by the Committee on Banking and Currency in April 1930. See S. Rep. No. 493, 71st Cong., 2d Sess. (1930). The resolution had been introduced in May 1929 by Senator King. See S. Res. 71, 71st Cong., 1st Sess., 71 Cong. Rec. 1830 (daily ed. May 24, 1929).

5 12 U.S.C. sec. 24. Section 16 governs the activities of national banks. Section 5(c) of the Banking Act of 1933 applied the restrictions of section 16 to state member banks. See 12 U.S.C. sec. 335.

6 S. 4723, 71st Cong., 2d Sess., 72 Cong. Rec. 10,973 (daily ed. June 17, 1930).

Against this background a subcommittee of the Senate Committee on Banking and Currency chaired by Senator Glass conducted in early 1931 the first major set of hearings on the subjects ultimately covered by the Glass-Steagall Act.⁷ Under Glass' direction, the subcommittee focused on commercial banks' participation in speculative securities activities through the extension of credit to support such activities, through investment practices, and through securities affiliates. In an appendix to the hearings, the subcommittee suggested that "[t]he experience of the past 10 years lends spectacular confirmation to the view that the more intensive participation by commercial banks in the capital market exaggerates financial and business fluctuations and undermines the stability of the economic organization of the country."⁸ In a section of the appendix devoted to securities affiliates, the subcommittee stated that such affiliates were engaged in a variety of activities, ranging from acting as a real estate holding company to underwriting securities.⁹

Referring generally to securities affiliates, the subcommittee identified a number of ways in which the operations of such an affiliate might affect adversely the position of a bank. It is difficult to determine the precise nature of Congress' concerns, and more particularly the specific problems that were peculiar to bank underwriting affiliates, since Congress had such a broad conception of the functions of "securities" affiliates. The subcommittee appears to have been most concerned, however, about loan transactions between a bank and its affiliate. The subcommittee suggested that such debtor-creditor relationships were "very prevalent" and asserted that these relationships were the "most direct manner in which the affiliate [might] impair the liquidity of the bank. . . ."¹⁰ Ultimately, the question of potentially harmful securities or loan transactions between a bank and its affiliate was addressed by section 13 of the Banking Act of 1933, which added a new section 23A to the Federal Reserve Act.¹¹

Following the hearings, there was again a lull in efforts to curb the underwriting and investment activities of commercial banks. The continued deterioration of the banking system during 1931, however, increased the pressure for some congressional action. After a respite in early 1931, a "spate of runs began in March . . . and reached a high point in June, attacking the Midwest, Pennsylvania, and New York in particular, intensifying with the collapse of the major European central banks."¹² The situation was aggravated by Great Britain's abandonment of the gold standard in September. All told, there were 2,290 bank failures during 1931.

In March 1932 the Senate Committee on Banking and Currency held the second major set of hearings on the subjects ultimately covered by the Glass-Steagall Act.¹³ Glass' original bill had gone

7 See S. Rm. 71 Hearings, note 2 *supra*.

8 *Id.*, at 1001.

9 *Id.*, at 1057. The subcommittee's discussion highlights the broad scope of the term "securities affiliate" as used by Congress during its consideration of the Glass-Steagall Act. The subcommittee stated that securities affiliates served as: 1) wholesalers of security issues; 2) retailers of securities; 3) holding and finance companies; 4) investment trusts (engaged in buying and selling securities acquired purely for investment or speculative purposes); 5) assets realization companies (used to take over from the parent bank loans and investments that proved to be doubtful or illiquid); 6) mediums for supporting the market for the bank's own stock; and 7) real estate holding companies. The subcommittee noted that "in most cases" the securities affiliates "exercised a combination of these functions, and in some instances they have exercised all of them." *Id.*

10 *Id.*, at 1064. See also *id.*, at 1063-64 (subcommittee's discussion of other ways in which the operations of an affiliate might affect adversely the position of a bank).

Despite the critical view of affiliates taken by the subcommittee in the appendix to the hearings, it is noteworthy that Senator Glass apparently still had doubts about the feasibility of separating affiliates from commercial banks. At one point during the hearings he had stated: "Well I myself . . . rather question the feasibility maybe of abolishing [securities affiliates] because they have been permitted for so long to exist. It might create a confusion and embarrassment that would be worse than the evil itself." *Id.*, at 40. But Glass did say that if it were not possible to control securities affiliates, "[he] should be agreeable to prohibiting them." *Id.*, at 41.

11 For a discussion of this provision, see page 11 *infra*.

12 S. Kennedy, *The Banking Crisis of 1933*, 19 (1973).

13 See *Operation of the National and Federal Reserve Banking Systems: Hearings on S. 4115 Before the Senate Comm. on Banking and Currency*, 72d Cong., 1st Sess. (1932).

through two revisions, and the proposal that was the subject of the hearings included provisions that were more extensive and severe in their treatment of commercial banks' securities activities than the provisions in the bill Glass had introduced in June 1930. The new provisions were designed to separate commercial and investment banking. Representatives of the financial community opposed the bill and criticized it as extremely deflationary. In addition, the Federal Reserve Bank of New York characterized as "unwise" the provisions calling for "a divorce of the banking system and the capital market." Governor Harrison stated that these provisions would "disturb the mechanism of the capital market, the free functioning of which is now so important to a recovery from existing business conditions."¹⁴

Testifying for the Federal Reserve Board, Governor Eugene Meyer acknowledged that "affiliations between member banks and security companies have contributed to undesirable banking developments."¹⁵ Meyer noted, however, that there were "difficulties in the way of accomplishing a complete divorce of member banks from their affiliates arising from the fact that a law intended for that purpose is likely to be susceptible of evasion or else to apply to many cases to which it is not intended to apply."¹⁶ In this light, the Board was "not prepared . . . to make a definite recommendation" Meyer did offer a tentative suggestion, however, in the form of a proposal providing for the divorce of securities affiliates from member banks after three years.¹⁷ Meyer stressed the tentative nature of this proposal:

*"It is fair to say that, while the board is in agreement on the views stated, there has been a good deal of discussion of the thought that the question of divorce of affiliates might perhaps be better deferred, instead of acting at this time to be effective three years from now, and in the meantime to get reports and make examinations and then enact a law later. However, the suggestion here was agreed upon as the best we could think of at the present time in the light of existing information, or I might say in the absence of full information on the subject. We do not feel, in the absence of more definite information, any too great confidence in any recommendation that we or anyone else could make. But this is a suggestion for your consideration, which was the best we could evolve in the board with the assistance of our experts."*¹⁸

Later, Meyer stated that "the question as to separation of affiliates, in our minds, is in the realm of the unknown to a certain extent, because of the absence of full information, and the board offers no strong recommendation, although it submits a suggestion."¹⁹

Following the hearings, Glass again revised his bill and incorporated Meyer's suggestion. The committee report accompanying S. 4412 stated that "[t]he outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of overinvestment in securities of all kinds."²⁰ The report also stated that "a very fruitful cause of bank failures, especially within the past two years, has been the fact that the funds of various institutions have been so extensively 'tied up' in long-term investments."²¹ In contrast, it is interesting to note that

14 *Id.*, at 501 (letter of George L. Harrison, Governor, Federal Reserve Bank of New York). Governor Harrison's letter had been unanimously approved by the directors of the Bank. See *id.*, at 499.

15 *Id.*, at 388 (statement of Eugene Meyer, Governor, Federal Reserve Board).

16 *Id.*

17 *Id.* Congress ultimately seized upon Meyer's proposal in formulating section 20 of the Glass-Steagall Act.

18 *Id.*

19 *Id.*, at 400. In response to questions, Meyer had stated that "it is impossible to classify absolutely all affiliates that deal in securities as wicked and vicious." *Id.*, at 393.

20 S. Rep. No. 584, 72d Cong., 1st Sess. 8 (1932).

21 *Id.*

at the hearings in 1931, the Comptroller of the Currency made the following statement: "I think it can fairly be said that I know of no instance where the shrinkage in value of collateral or bank investments as far as national banks are concerned, has been responsible for any bank failure or very, very few of them."²²

Finally, the report on S. 4412 was very critical of bank affiliates. It stated that such affiliates "in many cases [devote themselves] to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank."²³ The report did not offer any specific examples of these problems. In fact, there was no evidence that commercial banks failed because of their own or their affiliates' underwriting activities. As the President's Council of Economic Advisers has observed, "there is no evidence to support [the] proposition [that] bank failures in the early 1930's were [attributable] to the role of banks in the securities business."²⁴

The Senate debated S. 4412 in May 1932. In addition to the provisions of interest here, the bill included a broad range of proposals unrelated to the securities activities of commercial banks. During the debate, Glass mentioned the banking community's continued opposition to the separation of securities affiliates from commercial banks, but suggested that "[t]he committee ascertained in a more or less definite way—we think quite a definite way—that one of the greatest contributions to the unprecedented disaster which has caused this almost incurable depression was made by these bank affiliates."²⁵ Glass stated that the affiliates "sent out their high-pressure salesmen and literally filled the bank portfolios of this country with these investment securities."²⁶ Glass offered no specific evidence to support these claims. In fact, the implication that the smaller banks were failing because of their investment in unsound securities forced upon them by the larger banks was not justified.²⁷

Although Glass tried repeatedly to persuade the Senate to vote on S. 4412, the Senate did not act before the end of the session. Spurred by President Roosevelt's election and a continued deterioration of the banking system, the Senate did pass S. 4412 in January 1933 during the lame-duck session of the 72nd Congress.²⁸ The House, however, failed to act on the bill.

In the early months of 1933, several events helped Glass considerably in his efforts to secure enactment of these proposals. First, the Pecora hearings on stock exchange practices focused public attention on questionable financial dealings.²⁹ The hearings revealed, among other things, that one commercial bank and its affiliate had failed repeatedly to disclose material facts to investors, that the affiliate had engaged in high-pressure sales tactics, that the affiliate had traded in the stock of the bank and participated in a range of manipulative activities, that the bank had provided the affiliate with customers, and that the bank had used the affiliate to relieve the bank of bad loans to the alleged

22 S. Res. 71 Hearings, note 2 *supra*, at 12 (statement of J. W. Pole, Comptroller of the Currency). It should be noted that the shrinkage in value of collateral and bank investments did become a widespread problem as the depression and the banking crisis deepened. In the face of ruin by depositors, banks were forced to achieve greater liquidity by dumping their assets on the market. For a discussion of the causes of the banking crisis, see pages 8-12 *infra*.

23 S. Rep. No. 584, 72d Cong., 1st Sess. 9 (1932).

24 *Economic Report of the President*, 148 (1984). For further discussion of this issue, see pages 9-11 *infra*. Moreover, the problem of an affiliate's maintaining a market for the bank's own stock was addressed by the Securities Exchange Act of 1934. See page 12 *infra*.

25 75 Cong. Rec. 9887 (daily ed. May 10, 1932) (statement of Sen. Glass).

26 *Id.*

27 For a discussion of this issue, see page 10 *infra*.

28 See 76 Cong. Rec. 2517 (daily ed. Jan. 25, 1933).

29 See generally *Stock Exchange Practices: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 239, 72d Cong., 2d Sess.* (1933).

detriment of shareholders.³⁰ Most of the abuses revealed by the Pecora hearings were addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934.³¹

In addition, in early March 1933 the National City Bank and the Chase National Bank decided to drop their securities affiliates.³² In making the announcement for the Chase, Winthrop W. Aldrich, its new chairman, went on to propose several major reforms designed to separate commercial and investment banking.³³ In this regard, it appears that Aldrich was primarily responsible for the inclusion of the provision that was to become section 21 of the Glass-Steagall Act,³⁴ which prohibits entities that underwrite or deal in corporate securities from receiving deposits.³⁵ These events represented a significant break in the banking community's opposition to Glass' bill.

In the end, the development of a full-blown banking crisis in late 1932 and early 1933 was probably the most important event leading to enactment of the Glass-Steagall Act. From 1921 to 1933, there had been more than 10,000 bank failures. Until 1932, the failures basically had been confined to small, rural, state-chartered banks. Senator Glass offered the following description of the 8,221 banks that had failed during the eleven-year period from 1921 to 1931:

"There are approximately 22,000 institutions called banks; but thousands of them were little pawnshops that never should have been chartered either by the Federal Government or by State governments. Fifty-nine percent, or 4,861 of these suspended banks had a capital of \$25,000 or less; 25 1/2 per cent, or 2,175 of these banks had a capital exceeding \$25,000 but not exceeding \$50,000; and of the 8,221 failures, only 37 banks, or four-tenths of 1 per cent, had a capital of as much as \$1,000,000. Over 60 per cent of these failures occurred in communities with a population of less than 1,000 inhabitants, and over 90 per cent of these failures occurred in cities and towns with a population of less than 25,000 inhabitants.

"It is, therefore, obvious that the problem is largely one of small rural bank failures." ³⁶

During 1932, however, the failures began to spread and at the end of that year and in early 1933 entire state banking systems began to collapse. The escalation of the panic put intense pressure on the New York banks, which were faced not only with demands for cash from their local depositors, but also with withdrawals by the interior banks. By early March 1933 bank holidays had been declared in about half the states, including New York and Illinois. Finally, President Roosevelt declared a national bank

³⁰ See F. Pecora, *Wall Street Under Oath*, 70-123 (1939).

³¹ See page 12 *infra*.

³² In March 1933, "[n]o other affiliates were . . . in process of liquidation, or had been previously dissolved, either because final passage of the Glass bill was anticipated or because banks welcomed the opportunity to rid themselves of affiliates which they had thought necessary or highly desirable during the twenties." Peach, "The Security Affiliates of National Banks," in *Wall Street and the Security Markets*, 158 (V. Carosso ed. 1975). The investment banking business had dropped off substantially, and "no one was prepared to predict how soon, if ever again, the commercial banking sideline might be able to pay its own way." Perkins, note 1 *supra*, at 522.

³³ See *Wall Street Journal*, Mar. 10, 1933, at 8; *New York Times*, Mar. 9, 1933, at 1. See also *Stock Exchange Practices: Hearings Before the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong., 2d Sess. 3977 (statement of Winthrop W. Aldrich, Chairman, Chase National Bank).

³⁴ See *id.*, at 4016, 4032 (statement of Sen. Glass) (colloquy between Sen. Glass and Winthrop W. Aldrich); J. Johnson, *Winthrop W. Aldrich*, 156 (1948). It is likely that Aldrich's announcement, and section 21 in particular, were directed at particular competitors. See S. Kennedy, note 12 *supra*, at 212-13; J. Brooks, *Once in Golconda*, 149, 211 (1970); 6 St. John's L. Rev. 193, 195-96 (1933); *New York Times*, Mar. 9, 1933, at 1; *Wall Street Journal*, Mar. 10, 1933, at 8. As Arthur Schlesinger has noted, "Aldrich's [announcement] was interpreted as a Rockefeller assault on the House of Morgan. . . ." A. Schlesinger, *The Age of Roosevelt: The Coming of the New Deal*, 434-35 (1958).

³⁵ 12 U.S.C. sec. 378.

³⁶ 75 Cong. Rec. 9892 (daily ed. May 10, 1932) (statement of Sen. Glass).

holiday. Combined with Congress' enactment of emergency banking legislation in early March,³⁷ this stabilized the situation and permitted the reopening of most of the surviving banks. A consensus had developed, however, on the need to reform the banking structure.

At the beginning of the 73rd Congress in March, Glass introduced a bill similar to the one that had passed the Senate in January. This bill was revised and a new version was introduced in May. The new version, S. 1631, included provisions substantially similar to all four sections of the Glass-Steagall Act.

In mid-May, the Senate Committee on Banking and Currency reported S. 1631 to the full Senate. The report accompanying the bill was similar to the one that had accompanied the bill that the Senate had passed in January, and, in fact, contained some language identical to language in the earlier report.³⁸

The Senate debated S. 1631 in late May. The statements of the bill's proponents were not much different from the ones they had made on prior occasions. At one point, for example, Senator Glass stated:

*"[T]hese affiliates, I repeat, were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange, to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since. They ought to be separated, and they ought speedily to be separated, from the parent banks; and in this bill we have done that."*³⁹

The Senate passed S. 1631 without a record vote on May 25, 1933.⁴⁰ Following a House-Senate conference on the legislation, which for present purposes basically resulted in adoption of the Senate bill, the Senate and House both approved the conference report on June 13.⁴¹ The legislation was enacted on June 16, 1933.

Analysis of Congress' reasons for adopting the Glass-Steagall Act

The proponents of the Glass-Steagall Act advanced four reasons for separating commercial and investment banking:

- commercial banks' securities activities had contributed to, if not caused, the stock market crash and the depression;
- commercial banks' securities activities (investment and underwriting) had caused the collapse of the banking system;
- there were problems associated with relationships between commercial banks and securities affiliates; and

³⁷ This legislation, among other things, granted the President certain emergency banking and currency powers, provided for the appointment of conservators for certain national banks with impaired assets, permitted the Reconstruction Finance Corporation to buy preferred stock, capital notes, and debentures of banks, and provided for emergency issues of Federal Reserve Bank notes. See M. Friedman & A. Schwartz, *A Monetary History of the United States 1867-1960*, 421-22, 427 n. 4 (1963).

³⁸ Compare S. Rep. No. 77, 73d Cong., 1st Sess. 8-10 (1933) with S. Rep. No. 584, 72d Cong., 1st Sess. 8-10 (1932).

³⁹ 77 Cong. Rec. 3726 (daily ed. May 19, 1933) (statement of Sen. Glass).

⁴⁰ See *id.*, at 4182 (daily ed. May 25, 1933). This discussion has focused on activities in the Senate because the House, at least with respect to the provisions of interest here, basically followed the Senate's lead. See, e.g., *id.*, at 3835 (daily ed. May 23, 1933) (statement of Rep. Henry Steagall). The House always had been more interested in federal deposit insurance than in the Glass-Steagall provisions. The debates on the Glass-Steagall provisions in the House were very similar to those in the Senate. See, e.g., *id.* It should be noted, however, that the House passed its version of the Banking Act of 1933 on May 23, 1933, two days before the Senate took final action. See *id.*, at 4058 (daily ed. May 23, 1933).

⁴¹ See *id.*, at 5863 (daily ed. June 13, 1933) (Senate); *id.*, at 5898 (daily ed. June 13, 1933) (House). See also *id.*, at 5861 (daily ed. June 13, 1933) (statement of Sen. Glass); *id.*, at 5892 (daily ed. June 13, 1933) (statement of Rep. Steagall).

* commercial banks had been involved in objectionable practices in the marketing of securities.⁴²

If each of these reasons is analyzed carefully, however, it becomes clear that none of them provided adequate justification for separating commercial and investment banking. In some instances, Congress had no support in the record for the conclusions it drew. Moreover, to the extent that there were problems with the banking system and abuses associated with commercial banks' securities activities, they were addressed far more precisely and effectively by legislation other than the Glass-Steagall Act.

The stock market crash and the depression Although economists disagree about which elements were most important in causing a depression of such unprecedented severity, there is general agreement that commercial banks' securities activities were not a significant factor. The gamut of opinion on the dominant causes is spanned by the Keynesian and monetarist viewpoints. The Keynesian view emphasizes the collapse in aggregate demand:

*"The shrinkage of employment, real output, and real income during the depression . . . reflected the failure of the prevailing economic system to translate the wants and desires of the people into a level of spending, or aggregate money demands for output, sufficiently high to make it profitable for business firms to employ all available labor, to utilize other existing productive resources, and to invest in new capital."*⁴³

The monetarist view focuses on the decline in the money stock. Two monetarists note:

*"The monetary collapse was not the inescapable consequence of other forces but rather a largely independent factor which exerted a powerful influence on the course of events. . . . Prevention or moderation of the decline in the stock of money, let alone the substitution of monetary expansion, would have reduced the contraction's severity and almost as certainly its duration."*⁴⁴

Neither of these polar views nor any of the diverse opinions in between attributes the economic collapse to the securities activities of commercial banks. This supports the view that Congress vastly overestimated the extent to which commercial banks' securities activities contributed to the development of the economic crisis.

It is also important to recognize that there was nothing particularly insidious about the securities activities of commercial banks, conducted either directly or through affiliates. Investment banking houses also were involved in the securities markets. Any problems or abuses that developed were not confined to the activities of commercial banks.⁴⁵ Moreover, to the extent that there were abuses that contributed to the crash, or aggravated its effects, they were addressed far more directly and effectively by the Securities Act of 1933 and the Securities Exchange Act of 1934 than by the Glass-Steagall Act, which simply limited the market participation of commercial banks. The Securities Act dealt broadly with the issuance and distribution of securities to the public. The Securities Exchange Act subjected the

42. In *Investment Company Institute v. Camp*, 401 U.S. 817 (1970), and *Securities Industry Association v. Board of Governors*, 104 S.Ct. 2979 (1984), the Supreme Court reviewed the legislative history of the Glass-Steagall Act and noted Congress' perception that commercial banks' securities activities threatened the stability of the commercial banking system and led to undesirable banking practices. The Court conducted this review to determine Congress' intent in passing the legislation and the Court's conclusions appear to have influenced significantly the decisions in these cases. It is important to recognize, however, that the Court's determination of legislative intent based on a review of the legislative history does not address, let alone confirm, the accuracy of the perceptions and assumptions on which the Glass-Steagall Act was based.

43. L. Chandler, *America's Greatest Depression, 1929-1941*, 1-2 (1970).

44. M. Friedman & A. Schwartz, note 37 *supra*, at 300-01.

45. See, e.g., V. Carosso, *Investment Banking in America*, 317-18, 322-29 (1970) (discussions, among others, of the practices of Lee, Higginson & Co. and Halsey, Stuart & Co.); J. Galbraith, *The Great Crash 1929*, 38-37 (1979).

exchanges to government regulation, outlawed fraudulent and manipulative stock exchange practices, and authorized the Federal Reserve to regulate the extension of credit to purchasers of securities.

The banking crisis The collapse of the banking system was attributable principally to basic defects in the American banking structure. These flaws were revealed in the more than 5,000 bank failures that occurred from 1921 to 1929 during a period of apparent economic prosperity. Banks' investment or underwriting activities did not cause these failures; rather, factors such as poor management, inadequate supervision, undercapitalization, the depressed state of staple agriculture, and improved methods of transportation, which had put larger, more efficient banks within easy reach of many of the smaller banks' former customers, created the banks' problems.⁴⁶

Even after the wave of failures that hit the nation during the 1920s, there were 24,912 separately incorporated unit banks scattered across the country in June 1929. Of these banks, 72% had capital of less than \$100,000. The devastating effects of a significant economic downturn on such a weak banking structure are not hard to imagine. The failure of these small banks led to an erosion of depositor confidence, to hoarding, and to runs.⁴⁷ The pressure created by these conditions made it difficult for even the soundest banks to survive. In 1932, Senator Glass noted:

*"[The failure of small banks], notwithstanding their inconsequential activities in some respects, created a psychology which was extremely detrimental to the whole banking and business community. When three or four small banks in any given section of the country in any State fail, the fact of the failure of three or four banks in that section, however small they may be, begins to create consternation, to undermine public confidence, and to create runs on the larger and stronger banks."*⁴⁸

As Senator Glass recognized, the system was vulnerable to runs, and once the runs started they were hard to stop. In the face of actual or anticipated runs, banks were forced to achieve greater liquidity by dumping their assets on the market. This had the predictable effect of reducing the value of the banks' remaining assets and making them all the more vulnerable to assaults by depositors. Two commentators describe the phenomenon this way:

"[A]ny runs on banks for whatever reason became to some extent self-justifying, whatever the quality of assets held by banks. Banks had to dump their assets on the market, which inevitably forced a decline in the market value of those assets and hence of the remaining assets they held. The impairment in the market value of assets held by banks, particularly in

⁴⁶ See, e.g., S. Res. 71 Hearings, note 2 *supra*, at 7 (statement of J. W. Pote, Comptroller of the Currency); S. Kennedy, note 12 *supra*, at 16; M. Friedman & A. Schwartz, note 37 *supra*, at 240; C. Bremer, *American Bank Failures*, 47 (1935). Eighty-two percent of the banks that failed during the 1920s were small, state-chartered, rural institutions. See S. Kennedy, note 12 *supra*, at 205. Of the banks that failed, 39% had capital of less than \$25,000, and 88% had capital of less than \$100,000. See C. Bremer, *supra*, at 47. Moreover, "about 70 per cent of all bank failures . . . occurred in twelve agricultural states of which 41 percent consisted of banks situated in seven Western grain states." H. P. Willis & J. Chapman, *The Banking Situation*, 315 (1934). See also S. Res. 71 Hearings, note 2 *supra*, at 3-7 (statement of J. W. Pote, Comptroller of the Currency); S. Kennedy, note 12 *supra*, at 16; M. Friedman & A. Schwartz, note 37 *supra*, at 240, 249; C. Bremer, *supra*, at 57.

⁴⁷ Two commentators have suggested that "the growth of postal savings deposits from 1929 to 1933 is one measure of the spread of distrust of banks." M. Friedman & A. Schwartz, note 37 *supra*, at 308 n. 8. In November 1914, postal savings deposits totaled \$55 million. By August 1929 they had grown by only \$100 million. In October 1930 they stood at \$190 million. Between then and March 1933 they increased to \$1.1 billion. *Id.*

⁴⁸ 75 Cong. Rec. 9889 (daily ed. May 10, 1932) (statement of Sen. Glass).

their bond portfolios, was the most important source of impairment of capital leading to bank suspensions, rather than the default of specific loans or of specific bond issues."⁴⁹

Similarly, the President's Council of Economic Advisers has stated:

*"It is now widely asserted that the length and severity of the banking collapse of the 1930s was not the result of overly risky bank portfolios. Rather, many economists argue that these failures became widespread, initially, because of the reluctance of the Federal Reserve System to engage in aggressive open market operations to counter the conversion of deposits to currency and, later, because of the Federal Reserve's failure to assure adequate liquidity to banks experiencing runs on their deposits. As banks scrambled to liquidate their assets to meet the demands of their depositors for currency, their asset values fell, thus creating insolvencies."*⁵⁰

This analysis suggests that there was no validity to Glass' notion that banks' "overinvestment" in speculative securities had led to the collapse of the banking system.⁵¹ It also indicates that there was no substantial evidence to support the argument that bank underwriting affiliates had contributed significantly to the failure of smaller correspondent banks by pressuring them into purchasing unsound securities. It is, in fact, implausible that underwriting affiliates were able to create artificial demand for securities. Rather, the increased demand for securities was attributable to factors such as the decline in banks' commercial loan business.⁵² The business boom during the 1920s had put many American businesses in a cash-rich position. Moreover, the public had developed an intense interest in investment securities. These conditions made it possible for businesses to pursue "internal and external financing not involving bank loans."⁵³ There also is no reason to believe that investment banking houses would not have met commercial banks' demand for securities in the absence of bank underwriting affiliates. Finally, to whatever extent these affiliates sold unsound or speculative securities to unwitting correspondent banks, the problem was addressed by the portion of section 16 of the Glass-Steagall Act

49 M. Friedman & A. Schwartz, note 37 *supra*, at 355. In support of their position, Friedman and Schwartz cite a study showing that from the middle of 1931 to the middle of 1932 railroad bonds lost nearly 36% of their market value, public utility bonds 27%, industrial bonds 22%, foreign bonds 45%, and United States government securities 10%. *Id.*, at 355 n. 65. Friedman and Schwartz go so far as to suggest that "[i]n the absence of the provision of additional high-powered money, banks that suffered runs as a result of the initial failure of 'bad' banks would not have been helped by holding solely U.S. government securities in addition to required reserves." *Id.*, at 356-57. They state: "If the composition of [the banks'] assets did not stop the runs simply by its effect on depositors' confidence, the banks would still have had to dump their government securities on the market to acquire needed high-powered money, and many would have failed." *Id.*, at 357. See also J. Galbraith, note 45 *supra*, at 158-59 ("Since the early thirties, a generation of Americans has been told, sometimes with amusement, sometimes with indignation, often with outrage, of the banking practices of the late twenties. In fact, many of these practices were made ludicrous only by the depression. Loans which would have been perfectly good were made perfectly foolish by the collapse of the borrower's price or the market for his goods or the value of the collateral he had posted A depression such as that of 1929-32, were it to begin as this is written, would also be damaging to many currently impeccable banking reputations.")

50 *Economic Report of the President*, 117 (1983).

51 To the extent that Congress was concerned about the volume of bank investments, irrespective of quality, it is interesting to note that the Glass-Steagall Act had little effect on this "problem." Under the terms of the Act, banks were free to continue to invest in all types of debt securities: "Obligations of the United States or general obligations of States or political subdivisions were not subjected to the restrictions of section 16. Moreover, banks could invest in other debt securities, including corporate debt, eligible for investment under criteria promulgated by the Comptroller."

52 From 1920 to 1929, commercial banks' deposits increased by 35.8% and their investments increased by 67.1%. Their loans, however, increased by only 27.2%. For national banks, the trend is even more pronounced. From 1920 to 1929, national banks' deposits increased by 25.8% and their investments increased by 64.3%, while their loans increased by only 9.7%. See Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics* (1943).

53 M. Friedman & A. Schwartz, note 37 *supra*, at 244-45. See also M. Nadler & J. Bogen, *The Banking Crisis*, 15-17 (1933).

that provided for regulation of certain bank investments by the Comptroller, and by the disclosure requirements of the Securities Act of 1933.⁵⁴

Any notion that commercial banks failed because of their own underwriting activities is belied by the years of experience preceding the stock market crash and the depression. State banks and trust companies had been involved in the investment banking business since the latter half of the nineteenth century with no serious adverse effects. National banks had been participating in the securities markets since the turn of the century, with The First National Bank in New York creating the first securities affiliate on record in 1908. These activities do not appear to have threatened the stability of banks.

It is noteworthy that the legislative history of the Glass-Steagall Act does not reveal any large bank failures attributable to the marketing or underwriting activities of a bank's securities affiliate. It is true that the failure of the Bank of United States was commonly attributed to the activities of its "securities affiliates."⁵⁵ Fraud, however, was primarily responsible for the failure of that bank. Moreover, the bank's affiliates were used principally to conduct the personal, and highly speculative, business ventures of the bank's officers, particularly in real estate. The affiliates were involved in the securities business only to the extent that they were used by the bank's officers to trade in the bank's own stock and to engage in other manipulative activities.⁵⁶ In short, the failure of the Bank of United States provided no support for separating commercial and investment banking.

Other provisions of the Banking Act of 1933 were far more responsive to the structural defects that led to the collapse of the banking system than the Glass-Steagall Act. In this regard, two commentators have asserted that "[f]ederal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War."⁵⁷ In the words of another observer:

*"Federal insurance of bank deposits, even to this day, has not been given full credit for the revolution that it has worked in the nation's banking structure. With this one piece of legislation the fear which operated so efficiently to transmit weakness was dissolved. As a result one grievous defect of the old system, by which failure begot failure, was cured. Rarely has so much been accomplished by a single law."*⁵⁸

54 It is interesting to note that Senator Glass apparently was not very familiar with the Securities Act of 1933 and displayed little interest in the legislation. See J. Seligman, *The Transformation of Wall Street*, 69 (1982).

55 See, e.g., S. Res. 71 Hearings, note 2 *supra*, at 1054.

56 See, e.g., P. Temin, *Did Monetary Forces Cause the Great Depression?*, 91-94 (1976); Perkins, note 1 *supra*, at 496-97; Warner, "Biggest Bank Failure," *Fortune*, 62 (Mar. 1933). In recent testimony before Congress, the Securities Industry Association cited examples of bank securities affiliates that incurred substantial losses. Richard H. Jenrette, Chairman, Securities Industry Association, Statement Before the Senate Comm. on Banking, Housing and Urban Affairs (Mar. 7, 1984). The examples were drawn from testimony at the Stock Exchange Practices Hearings, note 33 *supra*, in late 1933 and 1934. It is not clear that the losses were attributable to conventional underwriting or dealing activities. Although available information is limited, it is likely that the losses were attributable in large measure to depreciation in the affiliates' long-term investment portfolios. See, e.g., Stock Exchange Practices Hearings, note 33 *supra*, at 4981 (statement of Ferdinand Pecora, quoting the 1930 annual report to the stockholders of the Guardian Detroit Union Group) ("The Guardian Detroit Co. and Kenne, Higbee & Co., in common with most securities companies and individual investors, have seen the market price of their inventory decline to a figure below values which should obtain under normal business conditions. This inventory might be divided into two general classes: First, securities which have been purchased for resale; second, securities which were purchased to give us a more or less permanent position, where we have a special interest, and which we expect to hold for institutional benefit, regardless of market fluctuations. Most of the depreciation in inventory values has occurred in this latter class of investments. From the standpoint of operations, that is, the purchase and sale of securities, both of these companies during 1930 made an operating profit").

57 M. Friedman & A. Schwartz, note 37 *supra*, at 454.

58 J. Galbraith, note 45 *supra*, at 170.

The elements of the Banking Act of 1933 that provided for a stronger Federal Reserve also were more important to insuring the stability of the commercial banking system than the Glass-Steagall provisions. As the President's Council of Economic Advisers has observed:

*"Glass-Steagall now makes no important contribution to the protection of the public against bank failures or undue concentrations of economic power. Other government measures, such as Federal deposit insurance and broadened and strengthened Federal supervision, appear to have been more effective in that role."*⁵⁹

Perceived problems with links between banks and securities affiliates The problems Congress thought were associated with relationships between commercial banks and securities affiliates were addressed more precisely by legislation other than the Glass-Steagall Act. Section 13 of the Banking Act of 1933 added a new section 23A to the Federal Reserve Act that imposed limitations on a member bank's transactions with its affiliates. This new section addressed concerns about potentially harmful securities and loan transactions between banks and their affiliates. By strictly limiting such transactions, the section also reduced substantially the possibility that depositor confidence in a bank might be shaken by the existence of an unprofitable affiliate. In addition, the provision addressed the fear that an affiliate, in the knowledge that it had access to a bank's resources, would make hazardous investments. Under the terms of the section, the affiliate's access to those resources was limited. Moreover, the use of an affiliate to manipulate the price of a bank's own stock was addressed by the Securities Exchange Act of 1934. By authorizing the Federal Reserve to regulate the extension of bank credit to purchasers of securities, this legislation also reduced to a considerable extent any difficulty banks might have had in insisting upon the maintenance of adequate margins on loans to customers to purchase securities distributed by the bank's affiliate. Finally, rules already established at the time of the passage of the Glass-Steagall Act addressed Congress' concern that the existence of a securities affiliate might affect adversely the independence with which fiduciary duties would be exercised by a bank's trust department.⁶⁰ In fact, during the debate on S. 4412 in May 1932, Senator Robert Bulkley pointed out that "[i]t is a long-established rule of English and American law that a trustee may not profit by dealing with his trust estate."⁶¹

Abuses in the marketing of securities There is no doubt that there were abuses in the marketing of securities during the 1920s. These objectionable practices, however, were not confined to the marketing activities of commercial banks. They were common to the securities industry as a whole. These general abuses, such as failures to disclose material information and market manipulation, were addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934. Banks would be no more likely than investment banking houses to engage in those practices now.

Conclusion

The Glass-Steagall Act was not a finely tailored response to the problems confronting the banking system in 1933. In fact, the Act did not correct the basic structural defects that had led to the collapse of the banking system. These defects, as well as the problems and abuses Congress had identified in the marketing of securities and in the relationships between commercial banks and securities affiliates, were addressed far more precisely by legislative provisions other than those included in Glass-Steagall. While it is understandable that Congress was persuaded that financial abuses and the country's economic ills called for drastic action, the divorce of investment and commercial banking was an imprecise and overly broad legislative remedy.

⁵⁹ *Economic Report of the President*, 122 (1983).

⁶⁰ See generally "Conflicts of Interest" *infra*.

⁶¹ 75 Cong. Rec. 9912 (daily ed. May 10, 1932) (statement of Sen. Bulkley). See also, e.g., *Albright v. Jefferson County Nat'l Bank*, 292 N.Y. 31, 40 (1944).

Bank safety and soundness

One of the most critical public policy issues raised by proposed revision of the Glass-Steagall Act is how the change might affect the stability of the U.S. banking system. The public interest in preserving a safe and sound system is unquestionable. That interest would be furthered, not undermined, by allowing bank holding company subsidiaries to underwrite and deal in corporate securities: the ability to diversify by offering profitable services in response to market demand would strengthen bank holding companies without introducing greater risks than those associated with activities they already pursue.

Risks associated with corporate securities activities

Underwriting and dealing in corporate securities present the same kinds of risk as underwriting and dealing in U.S. government, municipal, and Euromarket securities, in which banks already engage. Banks also face similar risks in foreign exchange, gold, and other dealing activities. Moreover, the risks involved in underwriting and dealing in corporate securities are assumed for very short periods of time—often a few hours and seldom longer than a few days—and the assets involved are highly liquid. In contrast, bank lending activities frequently involve credit exposure for a number of years and relatively illiquid assets.

Underwriting and dealing activities generate substantial revenues despite occasional losses in individual transactions, just as most loan portfolios produce net profits. And just as banks limit exposure to any one borrower to control credit risk, an underwriter or dealer limits its position in particular securities. Finally, the SEC's net capital rules restrict the activities of securities firms, just as a variety of regulatory requirements constrains bank activities.

Underwriting and dealing In underwriting or dealing in corporate or government securities, the fundamental risk involved is that securities purchased as a principal may not be sold at a profit.¹ In underwriting, the maximum profit that may be earned is determined by agreement with the issuer or seller of securities. This constraint does not exist in dealing, where profits are entirely market-related. The ability to resell securities at a profit depends upon successfully assessing the market value of the securities (price risk) and managing exposure to market risk and firm-specific risk between the time the pricing decision is made and the securities are sold.

Price risk reflects the possibility that an underwriter or dealer may misjudge, at the time the pricing decision is made, the price the market will pay for the securities.² In the case of debt securities, the underwriter or dealer determines the price based on the market's perception of the company's credit quality. In the case of equity securities, the underwriter or dealer determines the price based on the market's perception of the company's future prospects.³ In pricing both debt and equity securities, the underwriter or dealer must consider aggregate demand in the market for the particular securities. An underwriter or dealer may inaccurately assess these factors or for business or competitive reasons may price the securities too aggressively.

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- 1 Because securities are held for short periods of time by an underwriter or dealer, potential default and insolvency problems are not a significant risk in conducting these activities. Banks, of course, purchase for their portfolios corporate debt securities that qualify as "investment securities" and have substantial exposure to default risk through their commercial lending activities.
 - 2 Debt securities represent more of a "commodity" than common stock and are priced in relation to the U.S. government securities market and against each other based upon investment rating and perceived quality differences within a particular rating.
 - 3 The underwriters' pricing of additional shares of an already traded equity security will generally be at or slightly below the quoted market price for the outstanding shares at the time of the offering. The underwriters' pricing of an initial public offering (IPO) of equity securities involves greater risk. To compensate for this, an IPO is usually brought to market at an attractive price to the investor. This tends to result in a successful underwriting and a favorable secondary market price. Issues that may involve greater risk because of size, uncertainty about the company's prospects, or general market conditions usually carry a larger underwriters' spread to compensate for those risk factors.

After the pricing decision has been made, events may affect the price at which the securities can be sold. Market risk involves events that affect the level of securities prices in general, such as interest rate trends and the economic outlook. Firm-specific risk involves events, such as the introduction of new products, that affect the value of a particular company's securities, independent of general market trends. Market risks in underwriting and dealing frequently can be controlled by various hedging techniques, most of which have become available only in recent years.

Dealers generally can control the duration of their exposure to market risk and firm-specific risk, and the period of time during which underwriters are exposed to these risks is usually short. During the registration period of a traditional negotiated underwriting, the underwriters distribute preliminary prospectuses to, and receive "indications of interest" from, institutional investors who normally purchase the major portion of corporate debt and equity offerings. Once the issue is priced, the underwriting agreements signed, and the registration statement declared effective (typically within hours), the underwriters confirm sales to these investors. As a result, the underwriters frequently have the entire issue sold on the effective date.⁴

Risk and return characteristics Data published by the Securities Industry Association present convincing evidence of the favorable risk and return characteristics of underwriting and dealing in debt and equity securities. Total industry "profits" from these activities (defined by the Securities Industry Association to include gross underwriting and trading revenues less losses and certain direct expenses) were \$2.9 billion in 1979, \$4.5 billion in 1980, \$5.8 billion in 1981, \$8.3 billion in 1982, and \$10.4 billion in 1983. Moreover, as indicated in Table 1, substantial profits were derived each year from underwriting and dealing in both debt and equity securities.

Another measure of the risks involved in underwriting and dealing activities is whether individual securities firms, despite the overall profitability of the industry, have gone out of business or have been forced to merge with other firms because of underwriting and dealing losses. Since World War II, no failure or forced merger of a securities firm of significant size has been reported to have been caused by losses incurred in underwriting or dealing in corporate securities. Instead, securities firms have typically failed or merged because of managerial and back-office problems, undercapitalization, and fraud or employee misconduct.⁵

Banks, like securities firms, have enjoyed favorable results in underwriting and dealing in U.S. government and municipal securities.⁶ Appendix A provides the annual securities trading profits, as defined by the federal banking agencies, of the 10 largest banks in the U.S. during the period 1979-1983. Again, since World War II, no failure or forced merger of a bank of significant size has been reported to have been caused by losses incurred in underwriting or dealing in U.S. government and municipal securities.

4 In a shelf registration under the SEC's Rule 415, the registration statement is already effective before the underwriters bid for, or negotiate the price of, the securities. However, before bidding or negotiating the underwriters would have previously taken "soundings" in the market, and the duration of their exposure to market risk and firm-specific risk is generally no greater than in a traditional underwriting.

5 See, e.g., Securities and Exchange Commission, *Study of Unsafe & Unsound Practices of Brokers & Dealers*, H. Doc. 92-231, 92d Cong., 1st Sess. 27 (1971); Special Subcommittee on Investigations, House of Representatives, Committee on Interstate & Foreign Commerce, *Review of SEC Records of the Demise of Selected Broker-Dealers*, 92d Cong., 1st Sess. App. B (1971); and Securities Investor Protection Corporation (SIPC), *1982 Annual Report*, 28 (1983).

6 In recent years, the volume of new issues in the municipal market has increased dramatically. New issues of long-term municipal securities in 1983 totaled \$83 billion, far more than the \$50 billion in new issue corporate bonds; in comparison, the volume of all corporate bonds, common stocks, and preferred stocks issued in 1983 totaled \$96 billion. *The Bond Buyer* (Dec. 6, 1984); *Corporate Financing Week*, "1983 Underwriting Totals" (special supplement) (Jan. 9, 1984). Issues of U.S. government securities offered in 1983 totaled \$186 billion (net). Board of Governors, Federal Reserve System, *Flow of Funds Summary Statistics* (Nov. 23, 1984).

Table 1

Profitability of securities activities

Profits earned by securities firms from securities underwriting and trading, 1979-1983^a

(In millions)	1979	1980	1981	1982	1983
Underwriting^b					
Equity	\$ 177	\$ 405	\$ 428	\$ 330	\$ 754
Debt	594	925	1 145	1 992	2 783
Trading^c					
OTC equities	440	666	609	658	1 381
Other securities ^d	557	577	551	839	1 045
Debt securities	1 161	1 896	3 083	4 463	4 418
Total	\$2 929	\$4 469	\$5 816	\$8 282	\$10 381

^a Source: Securities Industry Association, *Securities Industry Trends*, Table 1 (1973-78) (June 29, 1979); *id.*, at Table 3 (1979-82) (June 1, 1983); *id.*, at Table 1 (1983) (Oct. 12, 1984).

^b The SIA defines underwriting profits as the difference between the proceeds of securities sold and their purchase price, adjusted for discounts, commissions, and allowances received from or given to other brokers. Direct expenses associated with a specific underwriting may also be deducted from the proceeds of securities sold. Unrealized losses on securities unsold at the time the underwriting account was closed are considered as a deduction from the proceeds of securities sold. See Securities Industry Association, *Securities Industry Trends*, 8 (June 29, 1979).

^c The SIA defines trading profits as the gain (or loss) realized upon the sale of securities held by a securities firm for its trading account, together with interest and dividends received on trading account inventories. However, in calculating trading profits, the SIA apparently does not subtract expenses such as securities firms' cost of funds and direct expenses associated with trading activities.

^d Consists of all listed equities and all other non-debt securities, including commodity futures, futures on stock indices, and options traded on national exchanges. See Securities Industry Association, *Securities Industry Trends*, 7 (July 30, 1984); *id.*, at Table 1 (Oct. 12, 1984).

Banks' municipal securities activities are not only functionally similar to corporate debt securities activities but also involve, in certain respects, greater risks. Greater depth and liquidity usually exist in the market for corporate debt securities than in the market for municipal securities. Unlike corporate debt securities, the vast majority of municipal issues are sold in serial form, each maturity being relatively small in amount and trading as a separate issue. The resulting lack of depth is evidenced by the wide spreads in the secondary market. Opportunities to hedge exposure in municipal securities are also more limited than in corporate debt issues. In addition, price variations in the municipal market are sometimes exaggerated, compared to the corporate market, because the tax-exempt status of municipal securities results in lower coupons and thus greater changes in price for a given change in yield.

In the Euromarket, merchant bank subsidiaries of major U.S. banks are successful competitors in underwriting and dealing in the securities of corporate and sovereign issuers. Although the majority of these issues are straight debt securities, denominated in U.S. dollars, substantial amounts are denominated in foreign currencies and some issues have equity features. The risks banking organizations face in these activities are comparable to, and in some ways greater than, the risks they would face in engaging in corporate securities activities in the United States. There is considerably less depth and liquidity, and hedging techniques are more limited, in the Euromarket than in the U.S. The favorable performance of bank affiliates' underwriting and dealing activities in the Euromarket indicates that bank safety and soundness would not be jeopardized if such activities were authorized for subsidiaries of bank holding companies in the United States.

Underwriting common stock Although the securities industry reports aggregate profits each year from underwriting equity securities, it is useful to examine in more detail the risk and return characteristics of this activity because it is generally considered "riskier" than underwriting debt securities. There is no

publicly available information, however, on the results of individual underwriting transactions. Only the underwriters know whether the syndicate successfully placed the entire issue at the public offering price, and therefore earned the full underwriters' gross spread,⁷ or sold some of the issue at a lower price.

Nevertheless, an indication of the revenues and losses from these transactions (including the number of transactions in which losses may have been experienced) can be obtained by comparing secondary market trading prices of common stock issues shortly after the offering date with the public offering price and underwriters' gross spread for such issues.⁸ Such secondary market prices are relevant because underwriters generally dispose of unsold positions as quickly as possible after syndicate price restrictions are terminated, which normally occurs on the offering date or on the following business day.⁹

Secondary market price data on the first, fifth, and tenth business days after each SEC-registered common stock issue of \$5 million or more during the period from 1976 through September 30, 1983 were reviewed.¹⁰ For each issue, the amount per share of any decline from the public offering price on each of these three days was subtracted from the underwriters' gross spread per share. The result was then multiplied by the number of shares in the offering to determine the total net underwriting revenues generated by the issue. The first business day after the offering date (*i.e.*, the second business day of the offering period) was selected because most syndicates terminate price restrictions and dispose of any unsold underwriting positions by this day. The fifth business day after the offering date was selected because most syndicates pay the issuer or other seller of the securities on that day and then begin to incur the direct cost of carrying any unsold positions. The tenth business day was chosen to provide an additional reference point, although underwriters rarely have any securities left to sell by this day.

Two assumptions were made in comparing the secondary market prices of an issue on these three days with the public offering price and underwriters' gross spread:

- If the secondary market price was at or above the public offering price on each of these trading days after the offering, it was assumed that the underwriters successfully placed the issue and earned the full underwriters' spread. Secondary prices would rarely, if ever, exceed the public offering price if there were underwritten securities to be purchased at the lower public offering price. In addition, secondary prices generally would not remain at the public offering price if the underwriters had not placed the entire issue at that price, because of the selling pressure that occurs when underwriters dispose of unsold securities.
- If the secondary market price was lower than the public offering price on any of these trading days after the offering, it was assumed that the secondary price represented the price the underwriters received in disposing of the *entire* offering. This assumption greatly overstates any negative results experienced by the underwriters in these transactions for two reasons. First, the entire issue may have been sold at the public offering price on the offering date, in which case any lower secondary market price on the first, fifth, or tenth days after the offering date would not reflect the price received by the underwriters for the securities. Second, even if the entire issue were not sold on the offering date (or before price restrictions were terminated), it is likely that at least some portion would have been sold at the public offering price rather than at the secondary market price utilized in the study.

7 Underwriters' gross spread is the difference between the public offering price of the issue and the price at which the underwriters buy the issue from the issuer (or other seller). The spread is subdivided within the underwriting syndicate into three parts: a special fee for the managers, a fee received by each member of the syndicate in proportion to the size of its underwriting commitment (less a deduction for syndicate expenses), and the selling concession retained by the syndicate members (or other broker/dealers) as compensation for the securities they sell to the public.

8 It was not possible to obtain comparable information on the results of underwriting corporate debt securities. Accurate post-offering secondary market trading prices are not available for debt securities because the vast majority of trades are over-the-counter transactions that are not publicly recorded.

9 The underwriters promptly dispose of unsold positions in order to free up their capital and to comply with SEC net capital rules. Before syndicate price restrictions are lifted, the underwriters are required to sell the securities at the public offering price.

10 These data were furnished by Abrahamsen & Co. It has collected such data since 1976.

The results of this analysis are summarized in Table 2, which shows the substantial net underwriting revenues generated each year when aggregate price declines are deducted from the underwriters' gross spread. The total value of price declines on the first day during the nearly eight-year period represents approximately 15% of the total underwriters' gross spread. The total value of price declines on the first day relative to the total underwriters' gross spread was greatest in 1980, at approximately 21%. Thus, even in 1980, the underwriters would have realized at a minimum 79% of the total gross spread.

Table 2

Underwriting revenues

Potential effect of changes in price on the first, fifth, and tenth days after the offering date of SEC-registered common stock issues of \$5 million or more, 1976-1983^a

Year	Value of all issues at public offering price	Total underwriters' gross spread	Value of price declines below public offering price			Net revenues resulting from subtracting the value of price declines from total underwriters' gross spread		
			Day 1	Day 5	Day 10	Day 1 ^c	Day 5	Day 10
			(In millions of dollars)					
1976	7 161	269.25	-30.64	-79.69	-130.75	238.61	189.56	138.50
1977	5 540	184.14	-21.04	-38.40	-54.73	163.10	145.74	129.41
1978	5 392	192.97	-29.32	-79.04	-106.24	163.65	113.93	86.73
1979	4 978	209.51	-24.38	-69.54	-91.95	185.13 ^b	139.97	117.56
1980	12 064	537.59	-112.75	-221.60	-314.44	424.84 ^b	315.99	223.15
1981	12 919	619.21	-84.38	-49.06	-65.22	534.83 ^b	570.15	553.99
1982	13 547	487.25	-91.04	-184.18	-185.12	396.21 ^b	303.07	302.13
1983	28 613	1 323.59	-185.28	-475.63	-620.64	1 138.31	847.96	702.95
1976-1983	90 194	3 823.51	-578.83	-1 197.14	-1 569.09	3 244.68	2 626.37	2 254.42

^a Results for 1983 are through September 30.

^b The total annual net revenues in this table exceed the profits compiled by the Securities Industry Association for all equity issues, which are shown in Table 1, because certain direct expenses associated with specific underwritings are subtracted in calculating underwriting profits in those data. In this table, no expenses are deducted to calculate the net underwriting revenues.

^c For the reasons previously noted, the revenues on the first day after the offering are likely to be more indicative of actual revenues than on the other two days.

The number of common stock underwriting transactions in which secondary price declines exceeded the underwriters' gross spread (thereby creating the possibility that the underwriters sustained actual losses) was also examined. Table 3 shows that, for the entire period, the number of transactions in which such declines occurred on the first day after the offering date is only 4.4% of the total number of issues.

Table 3

Frequency of significant secondary market declines of common stock issues ^a

Year	Number of issues	Number of issues with price declines in excess of underwriters' gross spread		
		Day 1	Day 5	Day 10
1976	169	5	18	34
1977	120	1	5	15
1978	165	9	27	35
1979	172	3	24	38
1980	363	22	59	85
1981	450	17	9	13
1982	340	18	55	64
1983	806	38	131	163
1976-1983	2 585	113	328	447

a As in Table 2, analysis includes SEC-registered common stock of \$5 million or more, 1976 through September 30, 1983.

Tables 2 and 3 indicate that common stock underwriting generates substantial net revenues and involves relatively few offerings in which the underwriters may have sustained actual losses. There remains, however, the theoretical possibility that one or more major unsuccessful underwriting transactions could place an individual underwriter in serious financial difficulty. To examine the possibility of such large destabilizing losses, the price that underwriters paid for the securities was compared with secondary prices on the three trading days after the offering.

As shown in Appendix B, there have been only four common stock issues from 1976 to September 1983 in which the secondary price declines (multiplied by the number of shares in the issue) exceeded the aggregate underwriters' gross spread by more than \$10 million. The largest indicated loss (\$45.3 million on the tenth day after the offering) was associated with the Phibro-Salomon offering of July 6, 1983. However, further investigation reveals that the entire Phibro-Salomon offering was sold at the public offering price on the offering date and that syndicate price restrictions were terminated on that date. Price declines on the fifth and tenth days, therefore, did not affect the underwriting syndicate's results. The next largest indicated loss shown in Appendix B involved the offering on October 21, 1982 of 2,995,600 shares of Eastman Kodak. But even if the syndicate's actual loss in this transaction was as large as indicated in Appendix B (\$18.5 million on the fifth day), the largest single underwriter's share of this loss would have been approximately \$5 million. A loss of this size, while not insignificant, would not have a destabilizing effect on an underwriter able to assume a major position in such an offering. Such an underwriter's capital base and its revenues from other underwriting activities would clearly enable it to withstand such a loss.

Insulating the bank from the securities affiliate

As discussed earlier, corporate securities activities do not involve greater risks than existing securities activities of commercial banks. Appropriate insulation of the bank from the affiliate would assure, moreover, that in the rare instance that a bank securities affiliate experienced financial difficulties, their impact on the bank would be minimal.

Separate capital As required under legislative proposals to permit banks to underwrite municipal revenue bonds and sponsor mutual funds, a bank securities affiliate would be a holding company subsidiary rather than a bank subsidiary. As a result of the affiliate's separate capitalization, any losses it incurred would not impair the capital of the bank. An affiliate would also have to maintain sufficient capital, in relation to the nature and volume of its securities activities, to comply with the net capital

requirements of the SEC. In addition, current legislative proposals would give the Federal Reserve Board authority to disapprove a bank holding company's proposed investment in an affiliate if the Board determined that the capital resources or the management of the holding company and the proposed affiliate were insufficient to support the anticipated business activities.

It is also implausible that a bank's capital would be reduced to an unsafe level as a result of the payment of dividends to a parent organization in order to aid a troubled securities affiliate. In addition to the responsibility of bank management to maintain adequate capital and the constraints imposed by the marketplace, the International Lending Supervision Act of 1983¹¹ strengthened the powers of the federal banking agencies to establish minimum levels of capital for banks. In view of the severe penalties that can be imposed for failing to comply with minimum capital requirements, it is virtually inconceivable that a bank's management, without consulting with bank regulators, would reduce capital below the required minimum through the payment of dividends.

Limitations on loans to an affiliate The Congress that passed the Glass-Steagall Act was concerned that banks could be injured by making loans to or investments in troubled securities affiliates. The Banking Act of 1933, in adding a new Section 23A to the Federal Reserve Act, directly addressed this concern by placing limits on transactions between banks and their affiliates. Strengthened in 1982, Section 23A limits "covered transactions" with a single nonbank affiliate—including loans, extensions of credit, purchases of assets, and investments in the securities of an affiliate—to no more than 10% of bank capital. The amount of such transactions with all nonbank affiliates may not exceed 20% of bank capital.

Under Section 23A, loans and extensions of credit to nonbank affiliates must be fully collateralized to protect the bank from loss. Moreover, the purchase of low-quality assets from an affiliate is generally prohibited. Finally, Section 23A requires that all transactions between a bank and its affiliates must be conducted in a manner consistent with safe and sound banking practices.

Depositor confidence and funding Public confidence is the foundation of a safe and sound banking system. This confidence, in the case of any one institution, depends ultimately on the belief that a bank is solvent and will be able to meet its obligations. If a bank reports significant losses, if public fears about its financial condition develop, and if these fears are not allayed, the resulting loss of depositor confidence may lead to a run on the bank.¹²

Permitting bank securities affiliates to underwrite and deal in corporate securities would not increase the risk of loss of depositor confidence for at least three reasons.¹³ First, it is highly unlikely that any loss incurred by a securities affiliate would be large enough to impair its capital, let alone the capital of its parent bank holding company. As discussed earlier, securities activities do not produce

11 Pub. L. No. 98-181, sec. 908, 129 Cong. Rec. 10,659 (daily ed. Nov. 18, 1983).

12 The considerable body of evidence available on the funding experiences of banks that incurred losses in their own operations indicates that banks have been able to overcome short-term funding difficulties, provided the market perceived that they would remain solvent. In these cases, while some institutional depositors have withdrawn funds and others have required interest rate premiums, banks have generally been able to replace any temporary loss of deposits by obtaining funds from other banks. Insured retail depositors generally have not withdrawn funds to any significant degree.

Major funding problems do arise when doubts of a bank's solvency become widespread. For example, in the case of Continental Illinois, continued deterioration in the bank's portfolio and the poor quality of reported earnings led depositors to doubt whether the bank would continue to be solvent, and a massive withdrawal of uninsured liabilities occurred.

13 In *Investment Co. Institute v. Camp*, 401 U.S. 617 (1971) [hereinafter *ICI v. Camp*], the Supreme Court cited the legislative history as indicating congressional concern that public confidence in a bank would be impaired if its affiliate fared poorly. *Id.* at 631.

large, destabilizing losses but instead generate healthy profits. Second, any loss incurred by a securities firm can be measured readily, because the value of all securities must be marked to market;¹⁴ no uncertainty about the possible ramifications of a loss for the firm or its parent company would ensue. In contrast, the effect of loan losses on the value of a bank's total portfolio cannot be assessed with similar accuracy. Third, losses incurred by a securities affiliate would not threaten the bank's solvency because the capital and assets of the bank would be insulated from the affiliate, as shown earlier. In sum, it is unlikely that a bank would experience any significant funding problems as the result of a securities affiliate's activities.¹⁵

Banking system benefits

Bank holding companies would be strengthened rather than weakened by operating securities subsidiaries, which would provide holding companies with opportunities to diversify assets and revenue sources through activities that are highly profitable in relation to the risks assumed. As shown in Table 4, the annual after-tax return on equity in recent years for large investment banks was approximately twice the annual after-tax return on equity for the ten largest bank holding companies.

Table 4

Return on equity

Comparison of the annual after-tax rates of return on equity capital for investment banks and bank holding companies

	1979	1980	1981	1982	1983
Large investment banks ^a	19%	30%	30%	30%	24%
Ten largest bank holding companies ^b	16	16	14	13	13

^a Securities Industry Association, *Securities Industry Trends* (May 30, 1980; May 19, 1982; June 16, 1982; and May 14, 1984).

^b Weighted average. Calculated from data obtained from Keefe, Bruyette & Woods, Inc., *1984 Keefe Banking Manual*.

¹⁴ Securities that are marked to market are valued for accounting purposes at their closing market price.

¹⁵ There are only a few cases that illustrate the funding experience of banks when their affiliates suffered losses. The recent experience of American National Bank & Trust Company of Chicago illustrates how the market can differentiate between a bank and an affiliate that is experiencing difficulties. The loans and funding problems of Walter E. Heller & Company in 1981-1983 did not result in any funding difficulties for its bank affiliate, American National.

In the most extreme case of bank funding problems caused by loans elsewhere in the holding company, Beverly Hills National Bank reportedly experienced a 15% loss of deposits during December 1972 and January 1973 after its parent company, Beverly Hills Bancorp., defaulted on a portion of its \$13.6 million of outstanding commercial paper. In view of the insolvency of the parent company, which subsequently entered bankruptcy proceedings, and doubts about its management, the bank, which remained solvent, was sold by the Comptroller of the Currency to Wells Fargo Bank for \$12.2 million, a premium over the bank's book value.

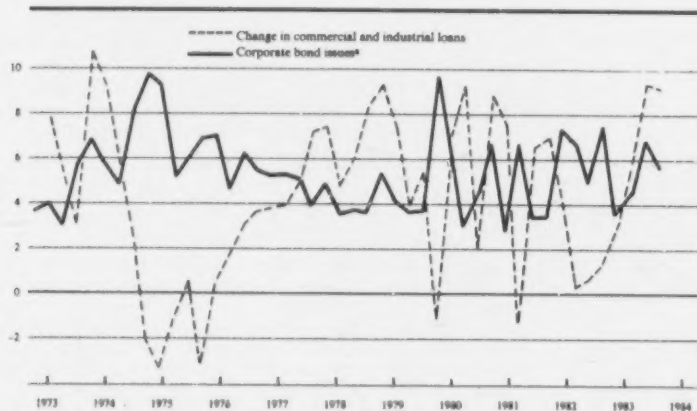
The failure of Hamilton National Bank of Chattanooga in 1976, which is sometimes cited as an example of a bank failure caused by an affiliate, did not result from funding difficulties caused by an affiliate's losses. The bank itself became insolvent as a result of its purchase of low-quality real estate loans from an affiliate, a practice now prohibited by Section 23A of the Federal Reserve Act, 12 U.S.C. sec. 371c.

Not only is the securities business more profitable than the banking business, but commercial bank entry into corporate securities activities would also allow banks to diversify their sources of revenue and reduce earnings volatility. As shown in the chart below, for example, corporate bond issuance and the growth of bank commercial and industrial loans are negatively correlated. When bond issuance is high, the demand for bank loans is low; when bank loan demand is high, bond sales tend to drop off. Thus involvement in the corporate securities business might well prove beneficial in enabling bank holding companies to even out swings in earnings associated with changes in loan demand.

Corporate bond issuance vs. loan demand

Volume of publicly offered corporate bond issues compared with change in bank commercial and industrial loans, 1974-1984

(In billions of 1972 dollars)



^a Publicly offered non-convertible debt, largely comprising corporate debt issues. Excludes syndicated agencies, federal, state, and local issues as well as tax-exempt pollution control financings and swaps; includes a limited number of underwritten offers by federal agencies.

Increased earnings generated by corporate securities activities would augment the capital resources of bank holding companies and facilitate their efforts to raise additional capital in the market. Additional capital in turn would enhance the safety and soundness of the banking system. Banks' ability to raise equity capital has been constrained by the low prices of bank holding company stocks, which persistently have sold at a discount from book value in recent years. In contrast, the market—as represented by Standard & Poor's index of 400 industrial company stocks—typically trades at a premium over book value, as shown in Table 5. The differential reflects in part the poor returns (adjusted for risk) that the market anticipates for bank holding companies in their current lines of business.

Table 5

Market valuation of bank stocks

Comparison of ratios of market value to book value of bank stocks and large industrial company stocks^a

(At year end)	1979	1980	1981	1982	1983
S&P 400 Index	1.23	1.43	1.18	1.33	1.53
35 large bank holding companies	0.76	0.80	0.78	0.79	0.90

^a The Standard & Poor's 400 Industrials stock index is a subset of the broader, better known S&P 500 Composite stock index. The S&P 400 is used in this comparison because the S&P 500 includes several large bank holding companies. Sources: Standard & Poor's, Inc., *The Analyst's Handbook* (1983); Salomon Brothers, *A Review of Bank Performance* (1981), *id.* (1982), *id.* (1984). Bank data not comparable across years as universe changes.

Conclusion

Corporate securities activities generate substantially higher returns on capital employed than commercial banking activities and carry no greater risk. Expanding the range of permissible bank holding company activities to include underwriting and dealing in corporate securities would create opportunities for such companies to develop substantial new sources of earnings. A reliable revenue stream, generated by a diversified range of financial activities, strengthens a bank holding company's capacity to absorb current losses and make adequate provision against future losses. It also enhances the company's ability to generate the additional capital needed to support asset growth and to retain the confidence of the markets in which it operates. Far from jeopardizing the safety and soundness of the banking system, permitting bank affiliates to underwrite and deal in corporate securities would increase the system's stability.

Appendix A

Bank trading account net profits, 1979-1983^a

(In thousands)	1979	1980	1981	1982	1983
Bank of America	\$ 38 451	\$ 56 093	\$114 723	\$151 985	\$ 89,652
Bankers Trust Co.	76 872	104 680	120 853	217 740	186,334
Chase Manhattan Bank	22 501	49 211	72 749	83 052	71,445
Chemical Bank	(25 674)	(28 550)	12 418	23 037	73,633
Citibank	166 597	209 259	435 511	406 000	401,000
Continental Illinois	32 746	32 140	53 640	63 805	40,809
First Chicago	9 055	14 230	40 516	38 816	29,014
Manufacturers Hanover	14 925	17 640	26 267	46 554	75,571
Morgan Guaranty	56 712	84 199	100 179	137 875	124,304
Security Pacific	13 508	27 285	31 219	47 337	20,255

a. Source: Federal Deposit Insurance Corporation and Federal Reserve Board Year-End Reports of Condition and Statements of Income. The federal banking agencies define bank "trading account net profits" as the revenues banks receive from their dealing activities in securities held for dealing purposes, minus any losses realized from dealing activities. Trading account net profits also include interest paid to banks with respect to securities held in their trading accounts and commission income from underwriting and certain agency activities. However, in calculating trading account "net profits," the banking agencies do not subtract from these revenue expenses such as banks' cost of funds or various direct expenses associated with bank trading account activities.

Appendix B

Common stock issues in which aggregate secondary price declines exceed cost of issue to underwriters by more than \$10 million

Date	Name	Offer price (per share)	Underwriter cost (per share)	Market price minus underwriter cost (per share)			Number of shares (in millions)	Aggregate difference between market price and underwriter cost (\$ millions)			
				Day 1	Day 5	Day 10		Day 1	Day 5	Day 10	Maximum
7/16/83	Phibro-Salomon	\$35.63	\$34.43	1.33	-0.30	-7.55	6.00	8.0	-1.8	-45.3	-45.3
10/21/82	Eastman Kodak	94.75	94.28	-2.03	-6.16	-1.78	3.00	-6.1	-18.5	-5.3	-18.5
3/06/81	Cetus Corp.	23.00	21.65	-0.65	-1.65	-2.65	5.22	-3.4	-8.6	-13.8	-13.8
3/04/83	Fortune Systems	22.00	20.55	-0.55	-2.30	-2.68	5.00	-2.8	-11.5	-13.4	-13.4

Conflicts of interest

Those who oppose the affiliation of banks and securities firms maintain that conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Regulation rather than prohibition of activities, however, is the method of controlling potential conflicts developed under the federal securities laws, and this less restrictive approach would deal effectively with the potential conflicts of interest encountered by bank securities affiliates. Moreover, economic incentives to maintain the good will of clients are strong and would also significantly limit the exploitation of potential conflicts.

Economic disincentives to exploit potential conflicts

The exploitation of potential conflicts of interest by any company would jeopardize the company's reputation with its clients. The good will that a firm has developed with clients is essential to its continued ability to attract business and generate earnings; therefore, a strong economic incentive exists to refrain from actions that might harm the firm's good reputation. While exploitation of a conflict of interest might boost profits in the short run, over the long term such exploitation would cause clients to take their business elsewhere, threatening the firm's future growth and profits. As one study concluded:

"[I]t is imperative to recognize that the self-serving opportunities present in conflict-of-interest situations are usually not exploited. If such were not the case, fiduciary relationships would seldom have survived, regulations would rarely be intact, and the law would have had to intervene far more frequently than it has."¹

Regulation vs. prohibition

Banks have long faced potential conflicts, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser. In a 1936 study of the broker and dealer functions of securities firms, the SEC recognized the potential conflicts that exist when a firm acts in both capacities, noting that

"the over-the-counter house which conducts a brokerage business and which also takes underwriting positions . . . is under temptation to induce brokerage customers to purchase securities which it is anxious to sell . . . Whenever the broker and dealer functions are thus combined the profit motive inherent in the latter may be sufficient to color investment advice or otherwise affect the brokerage service rendered to customers."²

However, the drastic remedy of divorcing certain business activities from others because of potential conflicts is generally rejected because it imposes unnecessary economic costs on society. The SEC's 1936 study recommended against enacting legislation to separate the broker and dealer functions, and since that time Congress has relied on disclosure and regulation of potential conflicts rather than risk the economic consequences of separating these activities.³

Continued separation of commercial from investment banking is justified only if disclosure, regulation, and judicial remedies would provide inadequate protection against the potential conflicts that could arise from the affiliation of a bank and a securities firm. Analysis indicates that this justification is clearly lacking.

¹ E. Herman, *Conflicts of Interest: Commercial Bank Trust Departments*, xv (1975).

² Securities and Exchange Commission, "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker," 75-76 (1936).

³ *Id.*, at 109.

Potential conflicts

An examination of the potential conflicts of interest that the affiliation of banks and securities firms might present reveals that these conflicts are not substantially different from or greater than those faced by banks or securities firms individually. These conflicts, which are described in Glass-Steagall's legislative history and in *ICI v. Camp*,⁴ are discussed in the following pages.

Promotion vs. disinterested advice At the time the Glass-Steagall Act was passed, the promotional role of the investment banker was viewed as incompatible with the "obligation" of a banker to give disinterested investment advice.⁵ Regardless of whether some depositors in an earlier era may have looked to their commercial bankers for investment advice, commercial bankers have neither an express nor implied obligation to their depositors to provide them with such investment advice. The view that it is inappropriate for banks to have a "salesman's stake" in promoting a particular product or service ignores the realities of today's marketplace, in which banks, like other financial institutions, provide substantial investment advisory services and promote the sale of a variety of financial products and services to the benefit—not the detriment—of their customers. The narrow view of appropriate banking activities expressed in the legislative history and in *ICI v. Camp* must be reexamined both in light of the fundamental changes since 1933 in the laws and regulations governing securities activities and in light of market developments in the financial services industry that have radically altered the banking business.

The comprehensive securities laws and regulations that have evolved subsequent to the Glass-Steagall Act effectively control the potential conflicts that exist when a securities firm has "a promotional stake" in the sale of securities and at the same time provides investment advice to customers. These laws and regulations would apply in all respects to a securities firm affiliated with a bank and would provide to bank customers that do business with the securities affiliate the same protection currently received by customers of securities firms.

Disclosure requirements,⁶ antifraud provisions,⁷ and related rules and regulations insure that promotional incentives do not override the broker-dealer's duty to its customers. They establish standards for both general business conduct and the suitability of recommendations to customers regarding the purchase of securities,⁸ and they regulate discretionary accounts.⁹ Public confidence and concepts of fair dealing are critical to the securities business, as they are to the banking business. As described by the president of the Securities Industry Association:

*"The securities business rests on public confidence, confidence that the brokers and dealers with whom the public transacts business are . . . held to standards of fair dealing. . . . Public confidence is clearly enhanced by rules ensuring that brokers . . . are required to 'know' their customers and to make only those recommendations that are suitable for those customers, and so forth."*¹⁰

4 401 U.S. 617 (1971). In *ICI v. Camp*, the Supreme Court cited various hazards involving potential conflicts of interest that could arise if banks were to engage in certain investment banking activities.

5 See 75 Cong. Rec. 9912 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

6 See 15 U.S.C. secs. 77g, 77j (sections 7 and 10 of the Securities Act of 1933 [hereinafter the 1933 Act]); *id.*, at sec. 781(b) (section 12(b) of the Securities Exchange Act of 1934 [hereinafter the Exchange Act]).

7 See *id.*, at sec. 77q(a) (section 17(a) of the 1933 Act); *id.*, at secs. 78i(a)(4), 78j(b), 78o(c)(1) (sections 9(a)(4), 10(b), and 15(c)(1) of the Exchange Act); *id.*, at Sec. 80b-6(3) (section 206(3) of the Investment Advisers Act of 1940 [hereinafter the Advisers Act]). See also 17 C.F.R. secs. 240.10b-5, 240.15c1-4.

8 See *id.*, at secs. 240.15b10-2, 240.15b10-3; New York Stock Exchange Rule 405.

9 See 15 U.S.C. sec. 80b-6(3) (section 206(3) of the Advisers Act); 17 C.F.R. secs. 240.15c1-7, 240.15b10-5.

10 E. O'Brien, "In the Middle of the Regulation-Deregulation Road," in *The Deregulation of the Banking and Securities Industries*, 134 (1979).

The same regulatory framework is relied upon to control potential conflicts even when a securities firm is a paid investment adviser and thus has a fiduciary duty to its client.¹¹ For example, an investment adviser acting as principal in the purchase from or sale of securities to a client must disclose fully all material facts regarding the potential conflict of interest and must obtain the client's consent to the transaction.¹²

The banking business has changed significantly since 1933. Within the current legal framework, banks and their affiliates engage in extensive promotional activities involving not only deposit instruments but also a great variety of financial products and services, including municipal and government securities and fiduciary and other investment advisory services. Promotional activities have increased in recent years partly as a result of the deregulation of interest rates, as many banks and their affiliates seek to supplement net interest income with greater fee income and to diversify revenue sources by offering additional products and services. Such promotional activities have served to educate consumers about investment alternatives and thereby foster competition. Moreover, during the past decade, bank affiliates have become active in underwriting and dealing in corporate securities in the Euromarket and, therefore, are already engaged in promoting the sale of corporate securities. In short, banks and their affiliates have long been performing services and offering products in which they have a "salesman's stake" or pecuniary incentive without any adverse effect upon the banks or their customers.

Fiduciary responsibility The concern that banks might sell to their trust accounts securities that were underwritten or dealt in by their affiliates ignores the clear duty of a trustee to refrain from self-dealing, i.e., putting itself in a position where its interest is or might be in conflict with its duty.¹³ The proscription against self-dealing also applies to affiliates or subsidiaries of the trustee.¹⁴ A trustee that breached its duty of undivided loyalty to the trust by dealing with itself or an affiliate would be required to repay the misapplied trust funds with interest. The trustee would be liable even if the transaction were fair to the beneficiaries when consummated and any losses on the investments were not caused by self-dealing on the part of the trustee.¹⁵

Some states have codified the common law prohibition against self-dealing by state chartered bank trustees,¹⁶ and the Comptroller of the Currency has adopted regulations prohibiting self-dealing by

11 Both the courts and the SEC regard a paid investment adviser as a fiduciary who owes his clients an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963). See also 46 Fed. Reg. 41,771 (1981) (SEC Investment Advisers Act Release No. 770 (Aug. 13, 1981)); 11 Fed. Reg. 10,997 (1945) (SEC Investment Advisers Act Release No. 40 (Jan. 5, 1945)).

12 Section 206(3) of the Advisers Act, 15 U.S.C. sec. 80b-6(3), makes it unlawful for an investment adviser

"acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."

Similarly, an underwriter is under a duty to make full disclosure and obtain the consent of its client before selling securities as principal to an account over which it has investment discretion. See 17 C.F.R. sec. 241.10181.

13 See, e.g., *In re Ryan*, 291 N.Y. 376, 407 (1943).

14 2 A. Scott, *The Law of Trusts*, sec. 170.13 (3d ed. 1967).

15 See, e.g., *In re Peck's Will*, 273 N.Y.S. 552, 555 (Surr. Ct. West. Co. 1934); *In re Gerken's Will*, 254 N.Y.S. 494, 497 (Surr. Ct. Kings Co. 1931). Similarly, the trust beneficiaries could require the trustee to disgorge any profits made by the trustee as a result of self-dealing.

16 See, e.g., N.Y. Banking Law sec. 100-b, subd. 1.

national banks.¹⁷ In addition, self-dealing constitutes a "prohibited transaction" under the Employee Retirement Income Security Act of 1974 ("ERISA"),¹⁸ and substantial penalties are imposed for violations by fiduciaries of employee benefit plans.¹⁹

Even in a situation in which the trustee is expressly authorized by the trust instrument or by the trust beneficiaries to engage in transactions with itself or its affiliates, this authorization will not be upheld unless it can be determined that it was given knowingly, by persons fully competent to make an informed decision, and that the trustee acted honestly and in good faith.²⁰ Moreover, banks' fiduciary activities are subject to supervision by bank regulators through on-site examinations and periodic reports. Transactions in which an affiliate has an interest are scrutinized, and any violation of the prohibition against self-dealing would not only have a serious effect on the bank's reputation as a fiduciary, but could also subject the bank to regulatory sanctions and liability for losses.

The potential conflicts of interest that may arise when a bank acts as trustee and its affiliate underwrites or deals in corporate securities are no different from those that are faced by securities firms that provide fiduciary services and engage in underwriting and dealing activities as principal. The same potential conflicts are also present when a bank acts as trustee and the bank or its affiliate underwrites or deals in U.S. government or municipal securities. A 1975 study by the Department of the Treasury noted that "while the potential for conflicts exists, there is no record of actual conflicts arising from commercial bank underwriting of general obligation municipals during the past 40 years that they have engaged in such activity."²¹ The study stated that this issue was "probed extensively" in 1967 hearings before a Senate subcommittee, and concluded: "Opponents of commercial bank underwriting of revenue bonds were unable to present a single instance where a bank had been guilty of a conflict of interest in underwriting and dealing in general obligation issues."²²

Underwriting to salvage loans Another objection raised by those who oppose affiliation between banks and securities firms is that a bank may utilize its securities affiliate to underwrite securities of a

17 The Comptroller of the Currency's regulations provide:

"Unless lawfully authorized by the instrument creating the relationship, or by court order or by local law, funds held by a national bank as fiduciary shall not be invested in stock or obligations of, or property acquired from, the bank or its directors, officers, or employees, or individuals with whom there exists such a connection, or organizations in which there exists such an interest, as might affect the exercise of the best judgment of the bank in acquiring the property, or in such or obligations of, or property acquired from, affiliates of the bank or their directors, officers or employees."

18 C.F.R. sec. 9.12(a). In addition, the self-dealing prohibition is extended to purchases of securities from another member of a syndicate of which a trustee or an affiliate is a member, while the syndicate is open, if all members are responsible for a share of any unsold securities (i.e., an "undivided" syndicate). Comptroller of the Currency, TBC-19 (Sept. 25, 1981). The self-dealing prohibition is even applied to transactions between a trustee and itself or an affiliate that involve agency rather than principal transactions. The Comptroller of the Currency's recent policy statement on brokerage transactions states that national banks may effect such transactions through an affiliate on behalf of fiduciary accounts only if they are performed on a nonprofit basis. Comptroller of the Currency, TBC-23 (Oct. 4, 1983).

18 29 U.S.C. sec. 1106; 26 U.S.C. sec. 4975(c).

19 29 U.S.C. sec. 1109; 26 U.S.C. sec. 4975(a), (b). Moreover, a fiduciary is permitted to purchase securities from another member of a syndicate of which the fiduciary or an affiliate is a member only if neither is a manager of the syndicate and if certain other restrictive conditions are met. 40 Fed. Reg. 50,845 (1975) (U.S. Dept. of Labor Prohibited Transaction Class Exemption 75-1 (Oct. 31, 1975)).

20 See, e.g., *In re Balf's Will*, 280 N.Y.S. 128, 130 (1935). See also 2 A. Scott, *The Law of Trusts*, sec. 170.13 n. 13 (3d ed. 1967).

21 U.S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, 35 (1975). Similarly, there have been no allegations of self-dealing in connection with banks' activities as dealers of certificates of deposit or bankers acceptances.

22 *Id.* at 35 n. 41.

financially unsound company to facilitate the repayment of loans to the bank.²³ Underlying this objection is an assumption, highly questionable in this litigious society, that a bank securities affiliate would fail to comply with the rigorous disclosure requirements and antifraud provisions of the federal securities laws. The Securities Act of 1933 and Securities Exchange Act of 1934 as well as securities regulations impose upon an issuer, its directors, and the underwriters of an issue a duty of full disclosure of all material facts. These parties would subject themselves to civil and possibly criminal liability under the 1933 and 1934 Acts if they failed to disclose adequately in the prospectus for an offering the financial condition of the issuer, the intended use of proceeds of the offering, and the benefits that any of these parties would directly or indirectly derive from the offering.²⁴ In any judicial action involving securities underwritten by a securities affiliate for the purpose of obtaining repayment of loans to the bank, a court is likely to examine rigorously the underwriter's adherence to its duty of full disclosure.²⁵

Disclosures mandated under the securities laws also assist the rating agencies in making their determination of the credit quality of the securities and enable investors to determine whether the investment return appropriately reflects the risks involved. Both debt and equity securities are primarily purchased by institutional investors, who are fully qualified to analyze the information disclosed.

Imprudent lending Any concern that a bank may make imprudent loans to customers for the purchase of securities underwritten by its affiliate is based on the assumption that a bank would jeopardize its own assets so that its affiliate could earn a small fraction of the amount of those assets on the sale of securities, whether as agent or principal. The possibility of such imprudent lending was considered and rejected by the Federal Reserve in the application by BankAmerica Corporation to acquire The Charles Schwab Corporation, a retail discount brokerage firm. In its order approving this acquisition, the Board of Governors stated:

*"The possibility that Bank might make unsound loans to Schwab customers to maximize Schwab's profits is not substantial and is neither based on evidence nor reasonable. Moreover, it would not be rational for Bank to place its own funds at risk in an unsound loan merely to increase brokerage commissions earned by Schwab."*²⁶

- 23 A related concern associated with the existence of a banking relationship between a company and a bank affiliated with a securities firm is that the securities firm might obtain access to confidential information submitted by the company to the bank in connection with the latter's lending activities. The possible misuse of nonpublic information presents a potential conflict that banks and securities firms have confronted for decades. Both banks and securities firms have adopted "Chinese Wall" arrangements to prevent their investment management departments and trading departments, respectively, from obtaining access to nonpublic information submitted by clients in connection with lending or underwriting activities. Similar procedures may be necessary to prevent a securities firm from obtaining access to nonpublic information submitted to its affiliated bank. For a thorough discussion of this potential conflict faced by securities firms and a proposed solution, see Lipton & Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms," 50 N.Y.U. L. Rev. 459 (1975).
- 24 The 1933 Act requires that a registration statement state the purposes for which the securities are to be offered and the approximate amounts to be devoted to such purposes. See Item 4 of SEC Forms S-1, S-2 and S-3, incorporating Item 504 of Regulation S-K of the Securities and Exchange Commission, 17 C.F.R. sec. 229.504. See also *In re Mearns Oil Corp.* [1949] Fed. Sec. L. Rep. (CCH) para. 76,020 (prospectus found to be deficient for failure to disclose the amounts to be paid to persons in a material relationship to the issuer). Sections 11(a), 12(2) and 15 of the 1933 Act, 15 U.S.C. secs. 77k(a), 77l(2) and 77o, and sections 10, 18 and 20 of the Exchange Act, *id.*, at secs. 78j, 78e and 78f, impose civil liability and section 24 of the 1933 Act, *id.*, at sec. 77a, and section 32 of the Exchange Act, *id.*, at sec. 78ff, impose criminal liability.
- 25 Similarly, disclosure requirements would effectively prevent a bank from selling its bad loans by packaging them as pass-through securities for sale by a securities affiliate. Incomplete or misleading disclosure of the quality of loans contained in the pass-through security issue could lead to civil and possibly criminal liability, as discussed above.
- 26 *BankAmerica Corporation*, 69 Fed. Res. Bull. 105, 113 (1983). The Board's order has been affirmed by both the U.S. Court of Appeals for the Second Circuit and the Supreme Court. *Securities Industry Ass'n v. Board of Governors*, 716 F.2d 92 (2d Cir. 1983), *aff'd*, 104 S. Ct. 3003 (1984). Although Schwab acts as an agent, not a principal, the Board of Governors' logic applies to the relationship between a bank and its securities affiliate when the latter acts in either capacity.

It is also well recognized that few investors (other than broker-dealers) borrow to buy corporate bonds, that most loans to purchase equity securities (excluding loans to finance major corporate acquisitions) are smaller loans made to individuals rather than larger loans to institutional investors, and that loans to purchase equity securities are subject to the margin regulations promulgated under the 1934 Act.²⁷ The margin regulations apply to both bank and nonbank lenders financing the purchase or carrying of margin stock²⁸ when such lenders are secured directly or indirectly by margin stock. The regulations restrict the amount of such loans to the maximum loan value of the collateral, which in the case of margin securities is currently half its market value. The federal securities laws further limit the possibility of abuses in securities lending by prohibiting a securities firm from arranging for a loan, whether from its bank affiliate or otherwise, to a customer on a security underwritten during the preceding thirty days by the firm.²⁹

Some observers also voice the concern that a bank may lend imprudently to a company whose securities are underwritten by the bank's securities affiliate. This concern is based on the assumption that a bank would be prepared to make an unsound loan to a company simply because securities of the company had previously been underwritten by an affiliate of the bank. While a bank may at times make additional loans to a company experiencing financial difficulties in order to protect outstanding loans to that company, no similar economic incentive exists where a prior underwriting by an affiliate is involved. Such conduct is not expected of an underwriter or its affiliate, and there is little reason to believe it would be expected of, or engaged in by, a bank that has a securities affiliate. There was no substantial evidence during the Glass-Steagall hearings that such lending actually occurred, and the theoretical possibility of abuse is even more remote now, given the changed nature of investment banking relationships. Today, companies are more likely to use more than one investment banker for different transactions and, in the case of highly rated companies, to employ shelf registrations, in which the underwriters are often selected competitively. As a result, it is extremely unlikely that a bank-affiliated underwriter, even if it served as the manager of the syndicate, would feel obliged to assist an issuer experiencing financial difficulty by encouraging its bank affiliate to make loans that would not otherwise be justified.³⁰

Conclusion

Strong economic incentives to preserve good will and reputation, assets critical to the long-term financial health of any business enterprise, would serve as powerful constraints on the exploitation of potential conflicts of interest that might arise from the affiliation of banks and securities firms. Based upon the premise that various methods of control short of absolute separation of functions prevent abuse effectively, a regulatory framework has been established during the past fifty years under the federal securities laws to deal with potential conflicts. Disclosure requirements concerning the existence of conflicting interests provide investors with sufficient information to make informed decisions, and regulatory supervision and judicial enforcement remedies, both public and private, deter actual abuses and provide appropriate redress in those limited instances when abuses occur.

As discussed in the first section of this study, Congress reacted to the banking crisis facing the country in 1933 with sweeping prohibitions, when more precise and less restrictive remedies have proved effective in addressing problems prevailing at the time. The need to separate commercial from investment banking activities because of potential conflicts has never been demonstrated and does not justify preservation of the Glass-Steagall Act.

27 12 C.F.R. secs. 207, 220 and 221 (promulgated pursuant to section 7 of the Exchange Act, 15 U.S.C. sec. 78g).

28 "Margin stock" under the regulations includes equity securities registered or having unlimited trading privileges on a national securities exchange, certain OTC stocks, warrants to buy margin stock, and debt securities convertible into margin stock. 12 C.F.R. sec. 221.2.

29 See 15 U.S.C. sec. 78k(d)(1) (section 11(d)(1) of the Exchange Act), 17 C.F.R. sec. 240.11(d)-1.

30 Similarly there is no economic rationale for a bank to make unsound loans to a company whose securities an affiliate is planning to underwrite in order to enhance the marketability of such securities. A bank would be placing its own assets at risk in amounts which greatly exceed the potential earnings of the securities affiliate. Moreover, loans to an issuer prior to the time of the underwriting by an affiliate of the underwriter would have to be disclosed in the prospectus.

Competitive impact

Research shows that corporate underwriting markets are concentrated and that legal barriers to competition in these markets result in high costs and other adverse conditions for issuers of securities, as well as unusually high profits for the securities industry. Permitting bank holding company subsidiaries to underwrite and deal in corporate securities should increase the number of competitors in these markets, with commensurate benefits for issuers and investors. In the absence of compelling reasons to protect this sphere of economic endeavor from competition, the costs of restricting competition cannot be justified.

Concentration in corporate securities underwriting and dealing markets

In traditional negotiated underwritings, corporations select a lead or managing underwriter, and occasionally co-managers, to advise on the nature, price, and timing of an issue. The managers typically organize other participating underwriters into a syndicate that shares in the risks and rewards of purchasing the securities from the issuer and reselling them to the public. In shelf registration offerings made pursuant to SEC Rule 415, a single underwriter often assumes the risk of purchasing the entire issue and promptly resells it—often in large blocks to institutions and other major investors. Underwriters also deal in corporate debt and equity securities in order to make secondary trading markets for investors, trading profits for themselves, and to facilitate initial distributions.

National markets United States underwriting markets are concentrated and have been so for many years.¹ A group of approximately six firms dominates the origination and management of public offerings. Another 15 to 20 underwriters manage some offerings but more frequently engage in distribution activities as syndicate members.² The leading firms tend to serve the country's largest corporations.

Barriers to entry into the upper echelons of underwriters are high because of the value corporations place on an investment bank's reputation, track record, personnel quality, areas of specialization, and size.³ The effects of this emphasis on reputation are compounded because most corporations solicit public funds infrequently, and they consider the success of public offerings critical to their future well-being. Barriers to entry are also reinforced by underwriters' desire for cooperative relationships in assembling and running syndicates. This tends to encourage repeated reliance upon the same small group of firms when syndicates are formed. Rule 415 transactions require substantial capital resources as a precondition of participation, which has limited the number of firms competing to

1 See, e.g., S. Hayen, A. Spence & D. Marks, *Competition in the Investment Banking Industry* (1983); V. Carosso, *Investment Banking in America* (1970); I. Freund, et al., *Investment Banking and the New Issues Market* (1967); Schneider, "Evolving Proof Standards Under Section 7 and Mergers in Transition Markets: The Securities Industry Example," 1981 *Wisc. L. Rev.* 1 (1981).

2 The top firms (which in recent years have included Drexel Burnham, First Boston, Goldman Sachs, Merrill Lynch, Morgan Stanley, Salomon Brothers, and Shearson Lehman/American Express) are referred to in the industry as the "special bracket," the "super-bracket" or the "bulge group" because their names typically appear at the top of the tombstone advertisements of public issues. The second group is typically referred to as "major bracket" because their names appear just below the top firms in those advertisements.

3 In 1983, only 49 firms lead-managed more than two offerings, while the top five were lead managers for an average of 133 issues each. See *Investment Dealers' Digest, Directory of Corporate Financing* (1983).

manage these transactions.⁴ The most significant barrier to entry into the upper brackets is, of course, the artificial one erected by the Glass-Steagall Act, which has "effectively excluded the best-positioned potential competitive entrants"—subsidiaries of major bank holding companies.⁵

Table 1 shows the percentage of the total dollar volume of issues managed by the top underwriters for the period 1979-1983, using figures that give full credit to the lead manager of an issue. Underwriters and industry observers use such figures to describe corporate underwriting market share and concentration because of the power, prestige, and profits that managing underwriters gain from originating and marketing issues. These data do not take into account the distribution activities of participating underwriters. Table 2 reflects these activities, however, showing the percentage of total industry underwriting revenues earned by the top securities firms.

Table 1 Concentration of corporate underwriting

Percentage of the total dollar volume of U.S. corporate debt and equity underwriting managed by the largest securities firms^a

	1979	1980	1981	1982	1983
Largest firm	18%	19%	19%	16%	16%
Top 3 firms	45	42	49	47	40
Top 5 firms	63	62	65	68	59
Top 10 firms	85	86	85	89	83
Top 15 firms	94	95	93	95	91
Top 25 firms	98	99	97	98	96

^a Source: *Investment Dealers' Digest, Annual Directory of Corporate Financing* (1979); IDD Information Services, Inc. (1980-1983). Figures used give full credit to the lead manager handling the books.

Table 2 Concentration of underwriting revenues

Percentage of total securities industry underwriting revenues earned by the largest securities firms^a

	1971	1973	1980	1981	1982	1983
Top 4 firms	15%	25%	28%	—	—	—
Top 8 firms	25	38	41	—	—	—
Top 10 firms	—	—	—	50%	58%	46%
Top 16 firms	40	56	60	—	—	—
Top 25 firms	52	67	68	74	81	76

^a Securities and Exchange Commission, *The Securities Industry in 1980*, Exhibit VI-3 (Sept. 1981) (1971-1980 data); Securities Industry Association, *Securities Industry Trends*, Vol. X, No. 4, at 10, Table 9 (July 30, 1984) (1981-1983 data). Data omitted is not publicly available. The loosening of concentration from 1982 to 1983 can be attributed to a dramatic increase in underwriting revenues, from \$2.3 billion to \$3.5 billion, and a surge in common stock offerings, *id.*, at 8-9. This increase was particularly notable for initial public offerings, which increased from \$1.4 billion in 1982 to \$12.6 billion in 1983. *Id.*, at 9.

⁴ "The Traders Take Charge," *Business Week*, 58, 60-61 (Feb. 20, 1984).

⁵ S. Haynes, A. Spence & D. Marks, note 1 *supra*, at 24; see also *id.*, at 22.

There has been a reduction in the overall number of competitors since 1970, and there is some evidence of a trend toward increased concentration in the industry as a whole even as the size of the market has grown dramatically.⁶ While 410 firms acted as managing underwriters in 1970, only 282 firms did so in 1983.⁷ A recently published study has found that corporate underwriting markets are highly segmented by type of issuer as a result of specialization by the leading firms.⁸ The supply of underwriting services thus may be even more concentrated than industry-wide figures suggest.⁹

Many industry participants believe that SEC Rule 415, governing shelf registrations, has made the corporate underwriting management and distribution process more concentrated since its promulgation in March 1982.¹⁰ Under Rule 415, a public offering may be pre-registered by the issuer without the assistance of an underwriter and then may be placed "on the shelf" for up to two years. The issuer usually decides to sell the securities when market conditions appear particularly favorable. Under Rule 415, underwriters negotiate or bid competitively to purchase and resell securities off the shelf in large blocks with little prior notification. Only a few firms have sufficient capital resources to compete to manage these distributions.¹¹ Time constraints have also made it difficult to assemble syndicates, reducing their size and increasing the proportion of the securities taken down by lead managers at the expense of smaller and regional firms.¹² The recent trend among leading investment banks to merge with larger companies has been attributed to a need for increased capital resources to permit participation in Rule 415 offerings and block trading.¹³

Most securities offered under shelf registrations have been resold to institutional rather than individual investors because of time constraints, the need for virtually instantaneous decision-making by investors, and the fact that most shelf registrations involve corporate bonds.¹⁴ These developments

6 The total dollar volume of underwritings was \$21.9 billion in 1969, \$79.0 billion in 1982, and \$102.4 billion in 1983. See *Investment Dealers' Digest, Directory of Corporate Financing* (1960-69, 1982, 1983).

7 See *Investment Dealers' Digest, Directory of Corporate Financing* (1970, 1982). See also S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 29-44; National Association of Securities Dealers, *Small Business Financing: The Current Environment and Suggestions for Improvement*, 24, 38-44 (1979).

8 See S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 67-77, 79-80. Eighteen investment banks formed four "quite distinct" competitive groups based on client attributes. *Id.*, at 89.

9 See *id.*, at 78-79.

10 See "The Traders Take Charge," note 4 *supra*, at 61 (top six underwriters managed 80% of Rule 415 volume in 1983 versus 65% of all corporate underwritings); "The 1984 Corporate Sweepstakes," *Institutional Investor*, 162, 164 (Mar. 1984) ("Indisputably, the top half-dozen firms are steadily gaining larger shares of all issues"). See also Letter of John C. Whitehead, Senior Partner, Goldman Sachs & Co. to John S.R. Shad, Chairman, Securities and Exchange Commission, 4 & Exhibit 4 (Sept. 12, 1983) (SEC File No. 37-979), 47 Fed. Reg. 39,803, 39,805 (1982) (dissenting comments of SEC Commissioner Thomas on Rule 415's extension). But see 48 Fed. Reg. 52,889, 52,893 (1983) (SEC adoption of final rule, stating that increased concentration and institutionalization stem from factors other than Rule 415).

11 See "The 1984 Corporate Sweepstakes," note 10 *supra*, at 163, 164; Wayne, "New Pressure in Investment Banking," *New York Times*, Apr. 15, 1984, Section 3 at 1, 24. See also Letter of Gordon S. Macklin, President, National Association of Securities Dealers to the Securities and Exchange Commission, 8 & s. 10 (Sept. 26, 1983) (SEC File No. 37-979).

12 See Adams, "Salomon's Number One," *Investment Dealers' Digest*, 8, 9 (Jan. 17, 1984). (The top 12 managers took down 34% of debt issues and 25% of equity issues before Rule 415 was introduced; afterward, the percentages jumped to 57% for debt and 42% for equity. For the top six managers, the percentages were 24% for debt and 13% for equity before Rule 415 and 40% for debt and 20% for equity thereafter; 25% of the dollar volume of Rule 415 transactions involved no syndicates.) See also Letter of S. Parker Gilbert, President, Morgan Stanley & Co. to the Securities and Exchange Commission (Sept. 12, 1983) (SEC File No. 37-979) (average syndicate size decreased from 90-125 members to 20-40 after promulgation of Rule 415). Final Rule 415, which is more restrictive than the original rule, permits shelf registrations only for offerings of high-quality debt securities of major issuers, those qualified to use short form registrations, and for "traditional" shelf offerings. 48 Fed. Reg. 52,889 (1983). This should not materially affect Rule 415's effect on concentration since short-form registrants already accounted for 94% of debt offerings and 90% of equity offerings filed under Rule 415 from March 1982 to September 1983. Power, "A Green Light for Shells, But With If Clauses," *Investment Dealers' Digest*, 11 (Jan. 10, 1984).

13 See Wayne, note 11 *supra*, at 1, 24.

14 See Letter of the Securities Industry Association to the Securities and Exchange Commission, 10-12 (Sept. 12, 1983) (SEC File No. 37-979).

have made the underwriting of major public issues under Rule 415 very similar to large block trading activities and have enhanced the market power of firms with the largest capital resources and greatest distribution capabilities.¹⁵

Dealing activities by investment banking firms have become more important in recent years because bond portfolio managers have become much more active traders of debt securities and because institutional investors have come to dominate secondary trading markets in equity securities of major issuers.¹⁶ These investors cannot readily make large block trades on national securities exchanges without the assistance of intermediary dealers. The leading investment banks and securities firms act as dealers in corporate bonds and as intermediaries in large block transactions. They purchase large quantities of securities and redistribute them, as quickly as possible, to new purchasers. The ability to deal in corporate securities is also integral to corporate underwriting activities, which often require purchases of securities for the underwriter's own account—particularly in Rule 415 distributions. Participation in such trades requires substantial capital resources, well-developed contacts with potential buyers, and the ability to assume and rapidly redistribute substantial securities positions. Consequently, as with shelf offerings, only a very few top firms participate.¹⁷

Market share data for dealing activities is limited. However, Table 3 shows the percentage of trading revenues earned by 21 major securities firms for the period 1980-1983. It shows a high degree of concentration and an increase in these firms' combined market shares over the period.

Table 3

Concentration of trading revenues^aPercentage of total securities trading revenues earned by large securities firms^b

	1980	1981	1982	1983
Ten large investment banks	35%	44%	45%	38%
Eleven national full line firms	30	29	38	44
Top 21 firms	65	73	83	82

^a Total securities trading revenues taken from Securities and Exchange Commission, *The Securities Industry in 1981*, 17 (Exhibit II-2) (Oct. 1982) (data for 1980 and 1981) and Securities Industry Association, *Securities Industry Trends*, Vol. IX, No. 6, at 4 (Table 1) (Nov. 25, 1983) (data for 1982 and 1983); revenues of large investment banks and national full line firms taken from Securities and Exchange Commission, *The Securities Industry in 1980*, 41 (Exhibit III-2) (Sept. 1981) (data for 1980); *The Securities Industry in 1981*, 26, 40 (data for 1981); and Securities Industry Association, unpublished estimates (data for 1982 and 1983).

^b The staffs of the Securities and Exchange Commission and the Securities Industry Association identified, for purposes of statistical analysis in the years included in this table, "ten large investment banks" (Bear Stearns, Dillon Read, First Boston, Goldman Sachs, Kidder Peabody, Lazard Freres, Lehman Brothers, Morgan Stanley, Salomon Bros., and Wertheim) and "eleven national full line firms" (Prudential/Bache, A. G. Becker, Dean Witter, Drexel Burnham, A. G. Edwards, E. F. Hutton, Merrill Lynch, Paine Webber, Shearson/American Express, Smith Barney, and Thomson McKinnon). The shares of trading revenues earned by each group are the best publicly available data showing concentration in those markets. It should be noted, however, that these 21 firms may not be those with the largest shares of trading revenues. Thus, concentration of trading revenues may be even higher than these figures indicate.

15 See "The 1984 Corporate Sweepstakes," note 10 *supra*, at 163, 164; Wayne, note 11 *supra*, at 24; "The Traders Take Charge," note 4 *supra*, at 60-61; "Salomon Brothers Led Competitors in '83 With \$15.76 Billion in U.S. Underwritings," *Wall Street Journal*, Jan. 6, 1984, at 27; "SEC Shelf Rule Proves a Boon to Brokers," *Wall Street Journal*, Oct. 18, 1983, at 25.

16 Trading revenues have increased as a percentage of total industry revenues from 19.2% in 1979 to 24.1% in 1983. Securities and Exchange Commission, *The Securities Industry in 1983*, Ex. 1 (1984). See also Securities Industry Association, *Securities Industry Trends*, Vol. IX, No. 3, at 8 (Table 4) (June 1, 1983) (large block transactions accounted for 43.3% of the total volume of securities transactions in the first quarter of 1983); National Association of Securities Dealers, *Analysis of Economic Impact of Market Maker Revenues*, 12 (Table 6) (June 1983) (in 1980 institutional trading accounted for 64.9% of all shares traded and 72% of their dollar value).

17 See, e.g., Wayne, note 11 *supra*, at 1; "SEC Shelf Rule Proves a Boon to Brokers," note 15 *supra*, at 25.

Regional markets Regional broker-dealers historically have served as managing underwriters for securities of smaller and emerging corporations and as distributors of issues managed by the leading firms.¹⁸ Regional firms also have made markets in stocks of small and emerging corporations. The number of such firms has substantially declined over the past 20 years, primarily as a result of mergers, stemming in part from reductions in stock exchange commission rates after fixed rates were abolished in 1975. More recently, regional firms have been weakened by their exclusion from Rule 415 offerings, as described above. With some notable exceptions, remaining firms lack the capital resources and personnel to engage in the full range of underwriting, research, and market-making activities essential to serve the financing needs of these corporations.¹⁹ As a result, many geographic areas have no local firms to act as underwriters and no active market-makers in securities of local interest.²⁰

Industry observers believe that this absence of regional underwriters and dealers makes public offerings by small and medium-sized companies unduly difficult and expensive, and discourages investment in their securities because of the illiquidity of secondary markets.²¹ The NASD has stated:

*"It was these local/regional broker-dealers that brought many local businesses public and provided secondary markets for their securities. Their demise will long be felt by those developing companies that will need their services in the future. Steps must be taken, therefore, to encourage and promote the re-emergence of this vital link in our nation's capital-raising system."*²²

The President's 1983 report on *The State of Small Business* stated that "[i]nnovation in the financial service industry will be the most important factor affecting small business in the next few years" and expressed the hope that financial market deregulation would lead to improved access to capital for small companies.²³ In the absence of Glass-Steagall barriers, regional banks would be logical new entrants competing to serve as underwriters of public issues and as dealers in securities for these companies.

Performance It appears that artificial barriers to commercial bank entry imposed by the Glass-Steagall Act have caused underwriting markets for corporate securities to be more concentrated than comparable underwriting markets in which commercial banks can compete. There is also evidence that the limited number of competitors in corporate underwriting and dealing markets has resulted in high profits for the securities firms that supply these services and in excess costs to issuers and investors.

Concentration levels are lower in markets where commercial banks now compete with investment banks than in similar markets where they do not. The Euromarket, in which U.S. and other major commercial banks compete, is much less concentrated than the domestic corporate debt market, from which banks are barred, as shown in Table 4.

18 See Schneider, note 1 *supra*, at 66-67 & n. 246, 83-84 & nn. 312-314; Securities and Exchange Commission & Small Business Administration, *Initial Public Offerings of Common Stock: The Role of Regional Broker-Dealers in the Capital Formation Process, Phase I Report* (Mar. 1980); Securities and Exchange Commission & Small Business Administration, *The Role of Regional Broker-Dealers in the Capital Formation Process: Underwriting, Market-Making and Securities Research Activities, Phase II Report* (Aug. 1981) (in the period 1979-1980, regional firms managed 92% of offerings of issuers with under \$10 million in revenues and 79% of initial public offerings).

19 See *id.*, at 4 (only 23% of regional securities firms that responded to a 1980 survey stated that they had managed initial public offerings, engaged in underwriting or research, or made markets in over-the-counter stocks).

20 See National Association of Securities Dealers, note 16 *supra* (14 states have no market-makers; 10 have only one or two; NASDAQ market-makers were reduced from 442 to 407 in 1982 alone); "Congressmen Introduce Bill Creating Profit Reserve for Market-Makers," *Securities Week*, 3-4 (Sept. 19, 1983) (total number of market-makers was cut in half in the past 15 years).

21 See, e.g., National Association of Securities Dealers, note 7 *supra*, at 1-4, 7, *Access to Equity Capital and Business Opportunities: Hearings Before the Subcomm. on Tax of the House Comm. on Small Business*, 98th Cong., 1st Sess., 22 (1983) (statement of Walter B. Stults, President, National Association of Small Business Investment Companies).

22 National Association of Securities Dealers, note 7 *supra*, at 4.

23 *The State of Small Business: A Report of the President*, xv (Mar. 1983).

The municipal general obligation bond market, in which commercial banks compete, is also considerably less concentrated than the municipal revenue bond market from which they are largely excluded, as shown in Table 5.²⁴ This is notable because both the Euromarket and the general obligation bond market are smaller in terms of total underwriting volume, and one therefore might expect them to be more concentrated.

Table 4

Concentration in corporate underwriting: Euromarket vs. U.S. market

Percentage of the total dollar volume of corporate debt securities underwriting managed by the largest securities firms in the U.S. and the Euromarket, 1980-1983.^a

	1980		1981		1982		1983	
	Euro	U.S.	Euro	U.S.	Euro	U.S.	Euro	U.S.
Top 4 firms	30%	58%	40%	65%	43%	59%	35%	60%
Top 8 firms	42	86	54	88	59	88	52	89
Top 10 firms	47	90	59	93	65	92	58	92
Top 16 firms	59	99	72	99	75	97	70	97
Top 20 firms	66	100	78	100	80	99	75	98
Total issues	225	495	275	459	337	571	296	605
Total dollar amount (millions)	\$11 680	\$41 345	\$15 823	\$40 514	\$25 194	\$43 645	\$21 121	\$52 162

^a Austin-Billinghurst Associates (Euromarket); IDD Information Services, Inc. (U.S. market). Figures used give full credit to the manager handling the bonds. Figures of 100% result from rounding.

Table 5

Concentration in municipal bond underwriting

Percentage of the total dollar volume of general obligation and revenue bond underwriting managed by the largest securities firms, 1980-1983.^a

	1980		1981		1982		1983	
	G.O.	Rev.	G.O.	Rev.	G.O.	Rev.	G.O.	Rev.
Top 4 firms	15%	23%	14%	27%	14%	27%	18%	27%
Top 8 firms	26	39	24	45	24	44	27	43
Top 10 firms	31	43	29	50	29	50	32	49
Top 16 firms	43	53	42	59	42	60	42	60
Top 20 firms	50	57	49	64	50	65	49	64
Total issues	2 938	2 630	2 220	2 459	3 132	3 133	3 018	3 528
Total dollar amount (millions)	\$13 805	\$33 915	\$12 396	\$34 520	\$20 739	\$55 281	\$21 468	\$63 626

^a Public Securities Association. *Statistical Yearbook of Municipal Finance: The New Issue Market* (1980-1983 editions). The figures used give proportionate credit to co-managers. Commercial banks are eligible to compete in selected revenue bond submarkets (those for housing, university, or dormitory purposes and those indirectly backed by the taxing power of the municipal entity). The revenue bond figures used in computing this table include those submarkets. Indeed, one commercial bank was in the top 20 and 7 were in the top 50 revenue bond underwriters. Therefore, this table tends to understate the impact on concentration of commercial bank exclusion from underwriting other types of revenue bonds.

²⁴ See also Hopewell & Kaufman "Commercial Bank Bidding on Municipal Revenue Bonds: New Evidence" 32 *J. Finance* 1047 (Dec. 1977); Clark & Saunders "Glass-Steagall Revisited: The Impact on Banks, Capital Markets, and the Small Investor" 97 *Banking L.J.* 811-822 (1980).

Major investment banking firms earn very large profits, which may result from lack of competition in many segments of their business, including corporate underwriting and dealing. Their returns on capital typically are disproportionately greater than those of companies in other industries, and very high earnings are concentrated in the most prominent firms.

After-tax return on equity for the 10 largest investment banking firms was 24% in 1983 and 30% in each of the preceding three years; in 1983 several major firms were reported to have earned pretax returns on equity of as much as 100%.²⁵ Moreover, after-tax return on equity for the securities industry overall was 19.8% in 1983, making it the most profitable industry group in the country.²⁶ In contrast, after-tax return on equity for the 10 largest bank holding companies in 1983 was 13%; for all banks and bank holding companies it was 11.6%.²⁷ The median for major U.S. industries in 1983 was 12.6%.²⁸

An important component of the profits of the leading investment banking firms is derived from activities from which commercial banks are not barred by Glass-Steagall, including providing advice on private placements, mergers and acquisitions, and other corporate finance transactions. Users typically consider expertise in securities underwriting and dealing, however, an important aspect of a firm's skill in providing these other corporate finance services. Thus, commercial banks' exclusion from securities underwriting and dealing also effectively restricts competition in, for instance, the mergers and acquisitions area.²⁹ It is not surprising that the same few investment banks that dominate the underwriting and dealing markets also handle the bulk of major corporate mergers. The extremely large fees paid to investment banks for their services in multibillion-dollar corporate acquisitions have been widely reported; to take a recent example, Merrill Lynch and Salomon Brothers will share some \$45 million and Morgan Stanley will receive nearly \$18 million in connection with the \$13 billion acquisition of Gulf Oil Corporation by the Standard Oil Company of California.³⁰

A recent article on Goldman Sachs gives some indication of the sizable earnings of the leading investment bankers:

"75 partners earned an average of \$5 million each ... [and] ... an estimate that more than 400 Goldman executives below the partnership ranks earned more than \$200,000 last year 'is not a wild guess,' according to one partner."³¹

Officers of publicly held firms also did well, with 17 top executives reportedly receiving \$1 million to \$2 million in compensation in 1983.³²

25 See Table 4, page 20 *supra* (return on equity for top 10 investment banks, 1979-1983); "Brokerage," *Forbes*, 36th Annual Report on American Industry, at 71, 72 (Jan. 2, 1984).

26 Securities Industry Association, *Securities Industry Trends*, Vol. X, No. 4, at 5 (July 30, 1984).

27 See Table 4, page 20 *supra* (return on equity for 10 largest bank holding companies, 1983); "Profitability of Insured Commercial Banks in 1983," *Federal Reserve Bulletin*, 802, 809 (Nov. 1984).

28 "Who's Where in the Industry Group," *Forbes*, 36th Report on American Industry, 249 (Jan. 2, 1984).

29 Binkley, "The Mergemakers' Spiraling Fees," *New York Times*, Sept. 30, 1984 Section 3, at 4, 24 (identifying eight firms as handling almost all major deals of more than \$500 million in value); "Investment Banking Proves a Tough Field for Commercial Banks," *Wall Street Journal*, Sept. 19, 1984, at 10.

30 "Gulf's Defeat and Its Lessons," *New York Times*, Mar. 10, 1984, at 35.

31 McGoldrick, "Inside the Goldman Sachs Culture," *Institutional Investor*, 53, 55 (Jan. 1984) (emphasis in original).

32 Parkert, "Making It At The Top," *Investment Dealers' Digest*, 7, 9 (May 15, 1984).

No data are available on the excess costs resulting from Glass-Steagall barriers to entry by commercial bank affiliates into corporate securities underwriting and dealing markets. There are, however, indications that deregulation would result in savings to issuers and investors. Deregulation of brokerage commissions and Rule 415's liberalization of underwriting regulations have shown that inefficiencies and excess costs have prevailed in the securities industry when regulations have presented barriers to competition. Following the deregulation of brokerage commissions in 1975, both commission rates and commission revenues dropped sharply.³³ Similarly, both the SEC and the SIA have concluded that Rule 415 has increased competition among underwriters for shelf offerings and has produced cost savings for registrants and their shareholders³⁴ as well as innovation in the form of new financing products.³⁵

Fee reductions resulting from the increased competition created by Rule 415 probably have been limited by the small number of effective potential competitors, since underwriters need large capital resources to participate in these large offerings.³⁶ Glass-Steagall exacerbates this problem by preventing large commercial banks from competing for Rule 415 distributions. The SEC's recent study on the impact of Rule 415 noted:

*"An inverse relationship between the intensity of competition among underwriters (as proxied by the number of underwriters bidding on an issue) and lower issuing costs has been extensively documented. . . ."*³⁷

A number of analysts have compared costs in the general obligation bond markets, in which commercial banks can compete with investment banks, to the municipal revenue bond market, in which they largely cannot. Most academic research has concluded that commercial bank participation has generated significant cost savings to issuers in the municipal general obligation bond market.³⁸ In a review of 12 studies conducted between 1959 and 1979 that investigated the impact on borrowers' costs of commercial bank eligibility to compete for competitively bid municipal issues, William Silber found

*"a remarkable degree of consistency in the findings of previous investigators of the link between eligibility and borrowing costs. Statistically significant impacts of bank eligibility on municipal borrowing costs emerged from virtually every research effort. . . ."*³⁹

33 See, e.g., Securities Industry Association, "A Primer on Discount Brokerage," *Securities Industry Trends*, Vol. IX, No. 1, 3-4 (Mar. 4, 1983) (after fixed commission rates were abolished on May 1, 1975 [Mayday], commissions charged to institutions dropped to one-third the retail level); Securities Industry Association, "An Industry Data Base As An Analytic Tool," *Securities Industry Trends*, Vol. VIII, No. 7 (Chart 3) (Mar. 15, 1982) (showing a sharp drop in indexed commission profit revenues over the 1976-77 period following commission deregulation).

34 These benefits have been enjoyed primarily by larger issuers, of course, since issuing debt securities under Rule 415 is not practical for most small companies. In addition, Rule 415 is not available for equity issues. The introduction of new bank-affiliated competitors as underwriters and dealers thus represents one of the few possible means to gain the benefits of greater competition for smaller issuers.

35 See Securities and Exchange Commission, Office of the Chief Economist, *Information Memorandum: Update—Rule 415 and Equity Markets*, OCE-84-09 (Sept. 4, 1984) (issuing costs for syndicated shelf offerings are 13% less than for comparable non-shelf issues and for non-syndicated offerings are 51% less; price performance of shelf issues in the secondary market is less than 1% worse than the performance of traditional offerings, a statistically insignificant difference); Securities Industry Association, *Securities Industry Trends*, Vol. X, No. 5, at 3, 13 (Aug. 22, 1984) (underwriting spreads on equity issues are 28% lower and issuance costs are 25% lower than for comparable non-shelf issues; however, the SIA claims that poorer price performance by shelf issues than by non-shelf issues outweighs these savings); see also 48 Fed. Reg. 52,889, 52,891 (SEC adoption of final Rule 415); "Investment Banking's Changing Face," *Wall Street Journal*, Jan. 4, 1984, at 24 (stating that under Rule 415 for equity underwritings, "[s]preads earned on raising money are narrowing to just those earned on large block trades.");

36 See Wayne, note 11 *supra*, at 24; "The 1984 Corporate Sweepstakes," note 10 *supra*, at 164.

37 Securities and Exchange Commission, note 35 *supra*, at 5.

38 See, e.g., U.S. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, 34 (1975) ("No systematic quantitative study that refutes these conclusions has been conducted").

39 W. Silber, *Municipal Revenue Bond Costs and Bank Underwriting: A Survey of the Evidence*, 6 (Salomon Brothers Center for the Study of Financial Institutions, 1979). The studies suggest that borrowing costs are reduced because both the number of bidders for an issue and the marketability of an issue are increased by commercial bank involvement.

When Silber applied alternative sets of relatively conservative assumptions to 1977 data, he estimated that the overall annual savings to municipalities resulting from commercial bank participation would have been in the range of \$80 million to \$369 million.⁴⁰

There are also indications that the increased competition resulting from banks' involvement as advisers in the private placement market may have lowered prices for advisory services. A 1978 report by the staffs of the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation stated:

*"It is quite possible that the commercial bank presence in the market for private placement services may, through competitive pressures, actually have reduced the cost and improved the quality of assistance provided by investment banking firms."*⁴¹

Industry observers have suggested that transaction costs in large block trades and in regional market-making could be reduced and that trades could be executed more efficiently if there were more dealers in those markets.⁴²

There is also evidence that the market for initial public offerings (IPOs) of equity may be inefficient. The initial public offering prices of new equity issues in general have been significantly lower than their secondary market prices immediately after issuance, indicating that issuers received less for their securities than the market later indicated investors would have paid.⁴³ One study concluded, for example, that IPOs were underpriced 18.8% on average from 1960 through 1982. In periods that were identified as favorable for new offerings, this study found that IPOs on average were underpriced 42.1%; for periods identified as unfavorable, the figure was 9.2%.⁴⁴

In addition, a recent survey of companies that went public during the period 1978-1983 indicates considerable dissatisfaction with the quality of service provided by the underwriters of initial public offerings. While most companies surveyed (92%) felt they made the right decision to go public, almost half (44%) would not use the same managing underwriter again.⁴⁵

Impact of bank holding company subsidiaries' entry

Removal of Glass-Steagall barriers will not result in the formation or acquisition of securities underwriting and dealing subsidiaries by all bank holding companies. But it will allow holding companies that perceive these new market opportunities as consistent with their long-range strategic plans to expand their product mix. It will remove serious legislative and regulatory inequities that permit securities firms to compete in many banking markets but bar bank holding companies and their subsidiaries from engaging in most securities activities. Creation of a "level playing field" will increase competition in all financial markets by removing regulatory barriers that may have led to unnecessary costs and limitations on innovation. It will also permit existing investment banking and brokerage firms to establish or to acquire full-service bank affiliates that complement their existing operations.

40 See *id.* (estimated present value of interest cost savings).

41 Comptroller of Currency, Federal Deposit Insurance Corporation & Federal Reserve Board, *Commercial Bank Private Placement Activities*, 11 (1978).

42 See "SEC Shelf Rule Proves a Boon to Brokers," note 15 *supra*, at 35; Shaeffer and Warner, "Concentration Trends and Competition in the Securities Industry," *Financial Analysts J.* 29, 32 (Nov.-Dec. 1977); Securities and Exchange Commission & Small Business Administration, Phase II Report, note 18 *supra*, at 41-44, 63 (discussing studies showing that inadequate research coverage and numbers of market-makers result in inefficient and illiquid markets).

43 This underpricing reduces the risk of underwriting, increases the marketability of new issues, and presumably results in a lower underwriting spread (the difference between the offer price and the price the underwriter pays the issuer for the securities); therefore, the loss of revenue for issuers is probably less than the raw data on underpricing suggest. Also, particularly in well-received issues, higher secondary market prices immediately after the offering may reflect the buying activity of investors who failed to receive the number of shares they originally sought.

44 Ritter, "The 'Hot Issues' Market of 1980," *Journal of Business*, 57, at 214-240 (Apr. 1984).

45 *A Study of the Attitudes of Companies Toward Going Public*, Lobenz-Stevens Inc. (1984); see also "Study Finds Widespread Dissatisfaction with IPO Underwriters," *Corporate Financing Week*, Vol. X, No. 15, at 1,9 (Apr. 16, 1984).

Allowing bank holding company subsidiaries to enter corporate underwriting and dealing markets will increase the number of actual and potential competitors, which should improve the performance of these concentrated markets. Both the Department of Justice and the Federal Trade Commission have supported repeal of Glass-Steagall limitations on the securities activities of bank affiliates because they recognize that

*"despite the general prohibitions of Glass-Steagall, there has been increasing competition between commercial banks and securities firms in recent years. These developments have demonstrated that increased competition from new entrants . . . increases innovation and results in the offering of services at the lowest possible cost to consumers."*⁴⁶

Prior to Glass-Steagall passage, commercial banking firms were the most effective competitors of investment banks in offering underwriting services, and they could become so again.⁴⁷

National markets A number of major commercial bank affiliates should be able to enter national underwriting and dealing markets as effective competitors with the top five national investment banking firms. The largest U.S. commercial banks are, of course, familiar with the operations and capital requirements of the country's major corporations. They are already engaged through subsidiaries in underwriting and dealing in securities in international capital markets. One U.S. bank affiliate was among the top 10 Eurobond managers and three others were in the top 30 in 1983.⁴⁸ They also act as advisers in the domestic private placement market⁴⁹ and as underwriters and dealers in state and local government general obligation bonds, where commercial banks comprised nine of the top 20 underwriters in 1983.⁵⁰ Some commercial banks have also provided advice to corporations on corporate finance and mergers and acquisitions. All of these activities have given commercial bankers knowledge, contacts, and experience that will facilitate their entry into domestic corporate underwriting and dealing.

As many of the largest bank holding companies would be likely to enter corporate underwriting and dealing markets by creating *de novo* subsidiaries, the total number of competitors for the underwriting business of major corporations would be increased. While it would be naive to assume that bank holding company subsidiaries could easily penetrate existing markets, major bank holding companies possess sufficient resources to capitalize independent subsidiaries at a level that would enable them over time to compete effectively with leading underwriters. Adequate capitalization would also make it possible for these subsidiaries to undertake dealing activities in large block transactions and to compete for Rule 415 distributions.

Regional markets Securities subsidiaries of many smaller bank holding companies could become effective competitors by augmenting the supply of underwriting services to smaller corporations, including the so-called middle market, which George Ball, president of Prudential-Bache Securities, has noted "Wall Street has perhaps ignored."⁵¹ In contrast to the depleted ranks of regional broker-

46 *Competition in the Financial Services Industry: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess., 410, 419 (1983) (statement of William F. Baxter, Asst. Attorney General, Antitrust Division, Department of Justice); *id.* at 418-441 (statement of George W. Douglas, Commissioner, Federal Trade Commission).

47 See S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 22, 24.

48 These figures are based on data, provided by Austin-Billinghurst Associates, that give full credit to the manager handling the books.

49 Two commercial banks were ranked among the top 15 private placement advisers in 1983. O'Toole, "The Commercial Banks Move In," *Investment Dealers' Digest*, 7 (Apr. 10, 1984).

50 See Public Securities Association, *Statistical Yearbook of Municipal Finance: The New Issue Market in 1983*, 22 (1984).

51 Osborn, "Will America Embrace Universal Banking?" *Institutional Investor*, 91, 101 (Feb. 1982, International Ed.).

dealers, there are hundreds of commercial banks with strong regional networks and customer bases. These institutions already serve smaller corporations as lenders and are familiar with their capital requirements.⁵² They also serve their communities as depository institutions, and a growing number are providing discount brokerage services.⁵³ For the stronger and more imaginative regional banks, expansion into underwriting and market-making activities would be a logical product market extension, absent Glass-Steagall barriers.

The presence of additional financial intermediaries in widely dispersed locations will give small and regional businesses the same access to capital markets now enjoyed by localities whose general obligation bonds are underwritten by local banks. Additional entrants will be well positioned to locate and assist companies that need public financing and to provide the research coverage and market-making capabilities vital to the maintenance of efficient secondary markets. It is likely to be more cost-effective and efficient for local bank holding company subsidiaries to provide such services than for distant national investment banking firms to do so. A narrowing of underwriting spreads for smaller companies, which now pay more for underwriting services than larger corporations, may also result.⁵⁴ If more regional broker-dealers made markets in the stocks of smaller corporations, the interest of individual investors in committing capital to local enterprises could increase, and such companies could improve their ability to raise capital. Removal of Glass-Steagall barriers could also strengthen small existing regional securities firms by allowing them to affiliate with local and regional banks.

Absence of bank dominance Entry by commercial bank holding company subsidiaries is unlikely to result in bank dominance or in increased concentration of securities markets. The commercial banking industry is generally much less concentrated and far more competitive than the securities industry.⁵⁵

Bank holding company capital resources would not make their securities subsidiaries overwhelming competitors of existing participants in corporate underwriting and dealing markets, as is sometimes suggested. The substantial capital resources of banks have not led them to dominate either the domestic or the international securities markets in which they now participate. Commercial banks' share of the general obligation bond market declined during the 1970s,⁵⁶ and in 1983 the top 50 general obligation bond managers included just 18 banks, which managed only about 31% of the dollar volume of issues managed by the top 50.⁵⁷ The commercial bank share of the private placement market has been modest, never exceeding 10%.⁵⁸ And U.S. commercial banks have not overshadowed U.S. investment banks in international markets.⁵⁹

52 "Banks' Rising Interest in Commercial Finance Reshapes the Industry," *Wall Street Journal* at 1, 18 (Dec. 22, 1983).

53 Approximately 600 banks and thrifts had entered the discount brokerage business by December 1982. See Securities Industry Association, *Securities Industry Trends*, Vol. IX, No. 1, 1 (Mar. 4, 1983).

54 See Osborn, note 51 *supra*, at 103 (stating that the middle market pays much wider spreads than larger corporations for public offerings (8-10% versus 3-4%) and for private placements (1/4% to 1% versus 1/8%)). This is justified to some extent by greater risk and distribution difficulty.

55 The top 20 bank holding companies, for example, made only 41.5% of total commercial and industrial loans in 1983. Data Resources, Inc., *Bank Analysis Service*.

56 See Bovenzi & Feinberg, "Issues Concerning Commercial Bank Participation in Selected Securities Activities," *Issues in Bank Regulation*, 27 (Summer 1982); Welles, "Wall Street's Last Gold Mine," *Institutional Investor*, 36 (Feb. 1978).

57 See Public Securities Association, note 50 *supra*, at 22.

58 Calculations for 1979-83 derived from O'Toole, "The Commercial Banks Move In," *Investment Dealers' Digest*, 7-8 (Apr. 10, 1984) (each of the top four investment banks has a larger market share than all competing commercial banks); Christie, "A Record First Half," *Investment Dealer's Digest*, 22-30 (Oct. 11, 1983); Christie, "1981—An Innovative Year in the Private Sector," *Investment Dealers' Digest*, 20-21, 38-39 (Mar. 30, 1982); Christie, "Private Sector in Slump During 1980," *Investment Dealers' Digest*, 34-36, 52-53 (Mar. 3, 1981); Christie, "Private Placements Decline in 1979," *Investment Dealers' Digest*, 20-22, 42-44 (Apr. 8, 1980); Comptroller of Currency, Federal Deposit Insurance Corporation & Federal Reserve Board, note 41 *supra*, (Table 2); Federal Reserve Board Staff Study, *Commercial Bank Private Placement Activities*, 31 (June 1977).

59 See "The 1984 International Financing Sweepstakes," *Institutional Investor*, 209 (Mar. 1984) (listing three U.S. commercial bank affiliates and five U.S. investment bank affiliates in the top 25 international bond managers, using data giving full credit to each manager).

Moreover, possession of adequate capital resources is only one of the prerequisites for entry into major underwriting and dealing markets. A firm's reputation, personnel, and experience are critical to its ability to obtain clients.⁶⁰ A bank holding company's total capital also has little or no bearing on the capitalization that would be made available to its securities subsidiary. Bank holding companies must make the most economically efficient use of their resources possible, and recent increases in bank capital requirements will further reduce any alleged incentive to overinvest capital in securities affiliates. Banks have not overcapitalized their existing Euromarket underwriting affiliates, and they have not made disproportionate investments in their domestic discount brokerage operations.

Concerns have been raised that removal of the anti-affiliation provisions of the Glass-Steagall Act might lead to increased concentration in the securities industry, through acquisitions or affiliations between major bank holding companies and the leading securities firms. Such combinations, however, would be subject to scrutiny for potentially anticompetitive market impact under existing banking and antitrust laws.⁶¹ Moreover, limitations on acquisitions that tended to increase concentration within the securities or banking industries could be adopted, upon repeal of the anti-affiliation provisions of the Glass-Steagall Act, if this were deemed by Congress to be in the public interest. Such legislation could also address issues raised by recent combinations of leading securities firms and by the merger of such firms with major corporations in the financial services, retailing, and insurance industries.

Nor would bank holding company securities subsidiaries possess unfair competitive advantages with respect to underwriting and dealing activities. These subsidiaries would be taxed on the same basis as other securities firms. Bank holding company restrictions on inter-affiliate dealings would insure that underwriting subsidiaries could not borrow at preferential rates from affiliated banks. Bank holding company securities subsidiaries would also be subject to all of the same regulatory requirements as their competitors.

Banks would not refuse to make loans to investment banking firms because they compete with the banks' securities affiliates, as has sometimes been asserted. Refusals to deal predicated upon anti-competitive objectives are prohibited by the Sherman Act.⁶² There is also no reason to believe that a bank with a securities affiliate would desert the broker loan market, which has always provided opportunities for banks to employ funds productively. A bank officer would be well aware that his counterpart at a competitor bank would lend to brokers if he did not.

Concern has sometimes been expressed that banks might unfairly condition corporations' access to loans upon their use of the services of their holding companies' securities subsidiaries. Banks, however, are expressly forbidden from tying access to loans to the purchase of investment banking or other services by Section 106 of the Bank Holding Company Act, as amended in 1970.⁶³ Concern has also been expressed about bank market power resulting from so-called "voluntary tie-ins" by corporations seeking both loans and underwriting services. There is little evidence that voluntary tie-ins have ever occurred in connection with bank lending or that they have been an issue in connection with bank

60 See McGoldrick, "How Rule 415 Has Put CFOs in the Catbird Seat," *Institutional Investor*, 88, 90-91 (Apr. 1984); see also S. Hayes, A. Spence & D. Marks, note 1 *supra*, at 48-49 (noting that many retail securities distributors and their acquirors have expended substantial resources in unsuccessful bids to break into the upper ranks of originating underwriters).

61 See, e.g., 12 U.S.C. secs. 1843(c)(8), 1842(c); Clayton Act, sec. 7. Mergers that served to diminish perceived potential competition or to entrench the power of existing competitors might be barred. See generally Department of Justice, 1984 Merger Guidelines, Sec. 4, 2 Trade Reg. Rep. (CCH) par. 6494 (1984); P. Areeda & D. Turner, 5 *Antitrust Law*, par. 1101 (1980).

62 See generally *Otter Tail Power Co. v. United States*, 410 U.S. 366, 377 (1973); Zito, "Refusals to Deal: The Sherman Antitrust Act and The Right to Customer Selection," 14 *John Marshall L. Rev.* 353 (1981).

63 12 U.S.C. sec. 1972. See also H. Rep. No. 1747, 91st Cong., 2d Sess., 18 (1970).

offerings of private placement advice and other services to corporations.⁶⁴ The credit markets are sufficiently open and competitive that loans from a particular bank rarely constitute a uniquely desirable product; instead bankers compete vigorously for corporate lending business.

It is much more likely that investment banking firms will continue to play a major role in corporate underwriting and dealing than that bank holding company subsidiaries might dominate these businesses. Investment banks' long-standing relationships with corporations, their experience, and their ability to offer a wide range of corporate finance services will continue to give them a substantial competitive advantage over new entrants.⁶⁵ In markets where commercial banks and investment banks now compete, issuers have exhibited a preference for using their traditional investment bankers for many products.⁶⁶ Further, amendment of Glass-Steagall would make it possible for investment banking firms to affiliate with banks and to offer a full range of commercial banking services in addition to their existing range of products if access were felt to provide a substantial competitive edge to those offering underwriting and dealing services to corporations.

Conclusion

Available evidence suggests that the high level of concentration in corporate underwriting and dealing markets results in higher costs to issuers and in poorer access to capital markets for smaller, less well-known companies than would be the case if artificial barriers to entry in these markets did not exist. Issuers and investors would benefit from the increased competition and innovation that would be the likely result of entry by bank holding company subsidiaries as new competitors in both national and regional markets. At the same time, there is no evidence that bank affiliates' participation in the corporate securities underwriting or dealing business would lead to increased concentration or other anticompetitive consequences. The benefits of increased competition in the securities markets make the wisdom of retaining Glass-Steagall's artificial barriers highly questionable. Removal of such barriers would reduce the costs and increase the quality of services to corporations and investors; keeping them preserves an investment banking monopoly, with classic negative consequences.

⁶⁴ The Federal Reserve Board rarely finds evidence of a potential danger of voluntary tying due to the competitive nature of credit markets. See, e.g., *In re Citicorp.* [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) par. 98, 708 (Apr. 16, 1982). See also Welles, note 56 *supra*, at 36 (quoting the treasurer of a large corporation as saying "[i]f any of my commercial bankers told me I ought to give them my private placement business just because I've got some loans out from them, I'd laugh in his face").

⁶⁵ See e.g., Federal Reserve Board Staff Study, note 58 *supra*, at 48-62 (correctly predicting that commercial bank private placement activities would not be likely to lead to commercial bank dominance or to increased concentration because commercial bank competitive advantages resulting from lending capabilities were offset by unique competitive advantages of investment banks).

⁶⁶ See generally Greenwich Research Associates, *Investment Banking 1983, Report to Participants*, 19 (1983) (survey of over 1,000 major corporations indicated commercial banks lagged behind investment banks in most of the 12 service markets in which both participate, particularly in the financial advisory and merger and acquisition areas).

The CHAIRMAN. Thank you, Mr. Preston.
Mr. Telling.

**STATEMENT OF EDWARD R. TELLING, CHAIRMAN AND CHIEF
EXECUTIVE OFFICER, SEARS ROEBUCK & CO.**

Mr. TELLING. Mr. Chairman and members of the committee, I thank you for the invitation to join you again. Your agenda is obviously full this morning, so my remarks will be brief and with your permission I will supplement them with some additional written material for the record.

In the 23 months since last I was with you, the pace of competition and innovation in the marketplace for financial services has continued to accelerate.

An increasingly sophisticated American consumer, afforded an ever broadening array of products and services, at more and more attractive prices, has made choices that are good for him or her and good for the American economy.

Each of the institutions represented at this table today has made an important contribution to that process and we hope that the same can be said of Sears, Roebuck and its affiliates.

SEARS' CONTRIBUTION TO THE NEW PRODUCTS AND SERVICES

We have now opened more than 300 financial centers in retail stores and the results have been instructive.

Dean Witter, for example, estimates that 35 to 40 percent of all the firm's new accounts are opened through the network centers. Furthermore, that 60 percent of those accounts are first-time brokerage accounts.

We have been pleasantly surprised that new account holders tend to be younger families, and that more than half are women—clearly a real expansion of the market beyond the stereotype of the traditional upper class, middle-aged, male brokerage customer.

Coldwell Banker is reporting equally encouraging results. Sales associates at network center locations are developing more listings and more sales per month than their average counterparts working in new, traditional real estate branches. And our latest figures show that through the end of 1984, revenues for Coldwell Banker's instore offices were nearly seven times ahead of comparable figures for 1983. This growth not only reflects an increase in the number of locations but also much improved results at centers that have been open for a year or more.

Allstate Insurance—which has long operated in Sears stores—is also experiencing significant gains at the network centers—especially in life and homeowners insurance.

And finally, California based Sears Savings Bank is finding that while virtually none of their new customers at traditional branches are first time bank customers, the branches in Sears financial centers report that 15 percent of their new customers have never before had a bank account.

We have been pleased with the evidence of public support for the direction in which we are heading. Consumer Digest last year gave Sears its prestigious Hall of Fame Award in recognition of our development of the retail financial network center concept.

An independently audited poll of the magazine's subscribers named Sears for its "outstanding service to America's consumers."

And according to a consumer opinion survey conducted by American Banker, Sears was No. 1 for innovation in financial services. More important, over half of the consumers polled by American Banker expect the quality of the service to be as good or better at Sears than at other financial institutions.

It is from the perspective of this experience, Mr. Chairman, that I would urge that this committee take as its task: How best to stimulate and to encourage this healthy trend of an improving environment for consumer investment and consumer savings.

To that end, I have recommended on other occasions, and I recommend to you today, that in lieu of preoccupation with closing so-called loopholes—instead of a mere concern with inhibiting the opportunities of consumers to make choices—that the Congress be as creative and as constructive and as innovative as the marketplace has been.

At least one step in that direction would be to set aside the strained and esoteric arguments over what is—and what is not—a bank and instead to create a new category of consumer bank or, more appropriately, family bank.¹

Such a family bank should be prohibited from making commercial loans. It should be limited to making loans for personal or family use, for charitable purposes, for small businesses, for family farms. In short, it should be encouraged to help average families reach their financial goals.

To ensure equal access to financial services, a family bank should be required to offer the option of no fee, no minimum checking accounts.

A family bank should likewise be required to prominently disclose its rate of interest, special fees, and other relevant consumer information.

A family bank should be accountable for the length of time it takes to credit funds to a customer's account, and be required to begin computing interest on funds deposited by check from the day it receives credit for the deposit.

A family bank should also be required to maintain some minimum percentage—say, 60 percent—of its assets in consumer loans.

To make sure that a local bank owned by a national firm kept faith with the community, a family bank should be required to make available, within its own State, loans equal to at least 60 percent of deposits generated within that State.

To ensure the safety of funds entrusted to its care, a family bank should be required to maintain a capital base substantially higher than current industry standards and to pay dividends only from current or the previous year's earning.

To protect against improper dealings between a family bank and its parent company, existing regulations controlling affiliate transactions should be rigidly enforced.

¹ Copy of proposed bill entitled "Family Bank Act of 1985", with a section-by-section summary, can be obtained from Sears, Roebuck & Co. Corporate Governmental Affairs Sears House 633 Pennsylvania Avenue, NW. Suite 600 Washington, DC 20004.

To guard against the possibility of coercion, a family bank should be required to disclose to customers that they have no obligation to deal with an affiliate in order to obtain credit or other financial services from the bank. In addition, antitying provisions which currently apply under the Bank Holding Company Act should also be extended to include family banks.

And finally, if regulators should determine that a family bank's stability was threatened because of its ownership, or because of any specific practices, an administrative hearing should be held. The bank or the parent company should be ordered to cease whatever practices contributed to the improper risk.

Now all that may sound like a full basket, but it really represents a very simple idea. Instead of attacking the problems of the banking system with a regulatory meat cleaver, we should be setting up a structure based on two fundamental imperatives—safety and consumer choice.

If we do so, we can give consumers what they want—equal access to financial services, the widest possible range of investment options, guarantees of safety and soundness—without turning back the clock, and without turning our backs on the innovations of recent years.

I don't mean to suggest that a free market approach may not result in some casualties. In the long term, any inefficient or poorly managed institution will fail—and it should. However, our Nation's financial system should protect the depositors, not the owners and managers of poorly managed institutions.

New rules of this kind will mean new competition. That is as it should be.

At Sears, for example, we would not oppose the right of traditional banks to offer insurance services in a properly regulated environment, even though Allstate represents a substantial portion of our total earnings.

Nor do we oppose suggestions that the Glass-Steagall Act no longer serves a constructive purpose.

That is because we believe—in the long run—a system in which the consumer interest is favored over any industry interest in maintaining a temporary competitive advantage, will be better for consumers and industries alike.

At the moment, though, the banking system is in an awkward position of transition. The game has already started, but the referees still haven't decided on the rules.

When I was with you in June 1983, Mr. Chairman, the central issue was whether or not there should be a moratorium of a few months until the 98th Congress agreed on an appropriate structure for the financial service industry.

Most of us on the witness panel at that time thought that such a step was inappropriate because the notion that a competitive economy can stand pat for an indefinite period of time does not square with reality.

For the same reason, Mr. Chairman, I would most strenuously oppose suggestions, largely emanating from the other body, that the Congress should act expeditiously just to close a loophole and then develop comprehensive legislation at its leisure. This type of short-term action penalizes the consumer and yet does not add to

the safety and soundness of the system. In fact, we have heard from several banking regulators that so-called nonbanks do not pose a safety and soundness threat to the banking system.

I fully appreciate the difficulty of resolving some of the controversies before you. And I appreciate that there may be a sense of frustration when the only apparent legislative option may seem to be to ratify changes which have already taken place. However, we believe that there are other approaches and we hope that you will take a close look at one such approach: The family bank proposal.

I commend you, Mr. Chairman, and others on this committee who have taken the constructive, though admittedly more difficult view, that the Congress should not act at all until it is prepared to act comprehensively so that those of us who have to make business plans and business decisions committing our resources, may do so with confidence that our success or failure will turn on whether or not we have met the needs and expectations of our customers.

Thank you for your attention and I will be pleased to do my best to answer your questions.

[The complete written submission submitted for the record follows:]

WRITTEN SUBMISSION

BY

EDWARD R. TELLING

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

SEARS, ROEBUCK AND CO.

BEFORE THE

SENATE BANKING COMMITTEE

ON THE ISSUE OF

THE CHANGING FINANCIAL SERVICES INDUSTRY

MAY, 1985

In 1984, and earlier this year, the public read about several examples of serious problems in the banking and thrift industries. Because of individual bank failures stemming from fraud and management abuse and difficulties of thrifts chartered under state insurance systems, the public, the regulators and this Committee are taking a closer look at these industries as a whole.

In this context, one of the central questions that this Committee is considering is: will banks be put at undue risk if their affiliates are allowed to compete with other segments of the financial services industry and consequently with entities primarily engaged in general commerce? The answer is that such competition will benefit the consumer.

Other industries which have been exposed to competition are instructive examples. When the airline industry was deregulated, weaker companies were no longer protected and were unable to survive. According to all estimates, however, the industry itself is stronger today than ever before. More important, the public is being better served through a greater variety of price structures and services.

Marketplace demands have already reconfigured the financial services industry, and therefore this Committee needs to consider broad-based legislation. Such legislation should: accept the realities of the financial marketplace; foster savings and investment; preserve to the maximum extent feasible the principles of free enterprise and vigorous competition; and assure a necessary degree of safety of the banking

system. Temporary quick fixes or putting a metaphorical thumb in the dike will not serve the public's best interests.

With these basic perspectives on the financial services issues as background, I will supplement - by this written submission - the oral comments I made before this Committee. We appreciate the opportunity to do so.

This additional material addresses certain fundamental issues raised by diversification of the financial services industry. In particular, those issues raised by the proposal referred to in my oral statement - the family bank proposal - will be examined.

Attached is a copy of the statutory language suggested to enact the family bank proposal, and a section-by-section summary and analysis to aid in understanding the purposes behind each of the proposed changes. Both documents are intended for inclusion in the record of these hearings and are provided to assist the deliberations of this Committee on how to meet consumer needs during this period of change in the industry.

Sears fully recognizes that certain concerns are being used as reasons for prohibiting the continued viability of consumer oriented banking institutions - whether they be called consumer banks or family banks. Those concerns raise various issues regarding ownership of banks by diversified nonbanking institutions.

The policy that opposes ownership of banks by diversified firms is traditionally expressed as a policy of separating banking from commerce. The principal concerns underlying this policy, as we understand them, are: safety and soundness of the banking system; concentration of resources; and abusive tying arrangements. We will briefly examine each of these.

Taking the safety issue first, the statement of concern can be expressed generally in this fashion: to permit firms engaged in general commerce to own banks could adversely affect the safety and soundness of the banking system as a whole. Many factors in the existing regulatory and statutory structure answer this concern. To begin with, guidelines regarding capital requirements, management expertise, and viable business plans which are requirements to establish or acquire control of banks apply with equal force to commercial enterprises desirous of establishing or acquiring a bank. Thus the substantial entry barriers to the banking business exist for all institutions as a precaution to preserve the safety and soundness of the system.

Once established, all banks, including those owned by diversified firms, are subject to the continuing scrutiny of state and federal regulators. Problems which arise can thus be treated as part of an ongoing regulatory process for all banks; regulators' hands are not tied - as some perceive they are - simply because of the ownership of banks by diversified firms.

Finally, if during the Committee's deliberations there appear to be regulatory or statutory gaps in the chartering or supervisory process, these gaps should be addressed in a specific fashion. This approach is preferable to a sweeping prophylactic response of merely drawing lines between industries because the issues are somewhat complex. Not only are such lines inherently anti-competitive, recent experience has shown that they are unlikely to be effective.

Sears, in the family bank proposal, does identify and substantively address many issues raised by the safety and soundness argument. For example, family banks would have to be capitalized at a higher level - 9 percent as an example - than traditional commercial banks. In addition, a substantial portion of the bank's portfolio must be in consumer loans which have traditionally been a safer, lower risk investment for banks and other financial institutions.

The Sears family bank proposal would expressly prohibit those affiliate transactions by family banks that some have suggested jeopardize the safety and soundness of the bank. These prohibitions insulate the financial activities of the family bank from those of its parent company and affiliates.

Sears therefore believes that the family bank proposal is a good step toward addressing, on a substantive basis, the safety and soundness concerns of diversification. Unfortunately, most of the discussions on the policy of separation of banking and commerce simply state that the policy is "traditional" and do not explore whether reasons still exist,

or ever really existed, to justify such a separation. In Sears estimation, the two industries may be dealt with in ways other than by merely separating them.

The concept of the separation between banking and commerce appears to be based on the notion that the providers of credit should be separate and apart from the users of credit. There are two reasons generally given for this: first, that our system of funding the financial needs of the economy through banking intermediaries should remain dynamic and not "tied" to any specific interest. Second, the perception exists that conflicts of interest may arise from combining commercial and banking interests. That is, the financing needs of one may be fulfilled by the other to the competitive detriment of other enterprises not affiliated with banks.

Both concerns may be answered by looking at the nature of the banking and financial services industry today. To begin with, the banking industry in this country is extremely dynamic - fully capable of meeting the funding needs of various segments of society. But due to competition and perhaps a reluctance on the part of the banking industry to meet all these needs, other providers of credit have developed, such as the securities industry which now provides short term funding needs through commercial paper and similar instruments. With this kind of dynamism and competition, the combination of banking and commercial firms has little impact on the source of funding for business and other credit needs. In addition, competition of the sort which exists in the financial industry diminishes possibilities for tie-ins or for financial

resources to be concentrated in one industry or one segment of the market.

It should also be noted that traditional concerns regarding combinations between banking and commercial enterprises revolve around the commercial lending capabilities of one and the commercial funding requirements of the other. The family bank proposal specifically addresses that issue by prohibiting commercial lending as an activity of a family bank and by prohibiting the upstreaming of funds from the bank to the parent or other affiliates except in certain narrow circumstances which do not include lending transactions. The consumer orientation of the bank avoids the creation of an institution that merely acts as a conduit funding source for a commercial enterprise.

It is also important to recognize that the terms "banking" and "commerce" are difficult to define because the activities they refer to are highly dynamic. The banking industry has been able to expand into new activities - such as discount securities brokerage operations, common trust funds, and data processing support systems - which have then been added to the list of activities understood to be "banking."

With the endorsement of the bank regulators and of Congress, this list may also be expanded to include many other securities activities, insurance activities, and real estate activities. Thus the range of what is understood to be "banking" is growing to encompass nearly all of the financial services industry, although "commerce" historically included securities, insurance, and real estate. Under this "new" look of a

"traditional" separation, banking thus encompasses nearly all of the financial services industry while commerce only includes retailing, manufacturing, mining and agriculture. This evolution underscores our point that it is not realistic policy to attempt to draw hard lines between banking and commerce.

While Sears favors an expansion of permissible activities for banks and their affiliates, we do so on the basis that institutions engaged in other activities be permitted to engage in banking. That is to say, the regulatory issues of combining banking with other expanded activities can be addressed in the same fashion and to the same degree of precision as combining nonbanking firms with banks.

Another concern is one dealing with abusive tie-ins of products and services between banks and their nonbank affiliates or parents. It is Sears position that the best preventive measure to deal with abusive tie-ins is a dynamic marketplace. An assurance of that dynamism is contained in proposals aimed at diversification of the financial services industry, permitting institutions to respond to customer needs.

However, if the Committee in analyzing these transactions finds that certain statutory safeguards should be considered, we would suggest those which were added to the family bank proposal. Those safeguards include extending the categories of "covered" transactions contained in section 23A of the Federal Reserve Act to family banks, prohibiting those transactions as between the bank and its parent company, and a provision for disclosure to customers of the bank where the bank is acting as an

agent for an affiliate in a permissible transaction. In addition to existing restrictions and regulatory authority as well as antitrust restraints, these suggestions sufficiently address the problems of possible abusive tie-ins.

Turning to other issues which are of concern to this Committee, the regulatory framework for the financial services industry is of major importance in a changing marketplace. Proposals such as the Vice President's Task Group recommendations to restructure the industry regulators are an important step in addressing such substantive issues. Although the final language of the Task Group proposal has not yet been made available, the concepts contained therein appear to be well thought out. In particular, the preservation of the dual banking and thrift regulatory system is extremely important to Sears. The Task Group proposal makes an excellent suggestion in the interest of preserving high standards for the industry by requiring that state regulators be subject to a federal certification standard. In light of recent difficulties in the industry, this proposal is appealing as a rational balancing of the interests involved.

Sears, therefore, urges the Committee to undertake the process of evaluating the industry's regulatory framework and, in so doing, favorably consider proposals which carry out a regulation by function approach. In that manner, regulatory agencies which have the greatest expertise in evaluating certain classes of transactions or certain segments of the industry would have full regulatory authority over those areas.

The Committee should also evaluate issues of federal, state, and private deposit insurance. This is partially due to recent difficulties experienced in Nebraska, Ohio, and Maryland. But to a great extent the issues of federal deposit insurance include an assessment of the investments in which insured funds are placed and the extent to which regulators should control those investments. Of course, an important consideration in this area is the preservation of depositors' confidence in the system.

Sears basically endorses the concept of risk related deposit insurance premiums. However, we stop short of endorsing the Federal Home Loan Bank Board's suggested legislation - S.759 - introduced by Senator Garn by request on March 26. That legislation would unfavorably impact many parts of the savings and loan industry under the guise of deposit insurance reform. As one example, the FSLIC could totally do away with deposit insurance for brokered deposits as an entire "class" of accounts even when those funds are being prudently invested by the healthiest of institutions. This type of regulatory authority overkill is one which this Committee should oppose and instead establish appropriate guidelines for a risk related insurance system.

As a further comment on S.759, Sears would oppose any attempt to enact the provision within that legislation which would restrict affiliations between savings and loans and securities firms. That provision would force the divestiture by Sears of either Sears Savings Bank or Dean Witter as well as impact similar affiliations of other institutions. There has been no shred of testimony presented to this

Committee that affiliations of this sort are harmful to the industry. To the contrary, the FHLBB should instead be looking to encourage well capitalized firms to acquire S & Ls to bring capital to the industry.

A final issue which has been brought to this Committee's attention is one which deals with the thrift industry. Unfortunately, the issue is one which has been characterized as a "problem" and has even been given the misnomer of the "nonthrift thrift." It is Sears understanding that the type of institution which is so classified is a unitary savings and loan holding company. That type of holding company - fully licensed, regulated, and operating under law - is one which controls one savings and loan institution.

Sears objects to the characterization that has been given to such holding companies as "nonthrift thrifts" as that terminology suggests a "less than regulated" thrift. It also suggests that the institutions are somehow not thrift institutions in the character of their portfolio.

Nothing could be further from the truth. Unitary S & L holding companies were created by Congress in 1968, fully recognizing the diversified nature of the activities of the holding companies. In recognition of these activities, restrictions and indeed prohibitions were placed on activities and transactions between the holding company and its depository institution. Both the Federal Home Loan Bank Board and FSLIC were granted broad regulatory authority, including cease and desist authority, to deal with any concerns which may arise.

Then in 1982, this Committee - in legislation which ultimately became the Garn-St Germain Act - placed a further restriction on unitary S & L holding companies. That restriction, with a purpose to retain the "thrift character" of the insured institution of such holding companies, requires a portfolio of at least 62% in residential mortgages or the holding company must divest the S & L.

Present criticisms of unitary S & L holding companies regard this form of ownership as a loophole rather than the advantage that it is for the S & L industry. Well capitalized companies, such as Sears, bring strength to the S & L industry, not weakness. However, proposals before Congress seek to limit this type of ownership even further under the guise of safety and soundness.

Sears position is that such proposals are unnecessary and duplicative while failing to address real problems in the industry - such as higher capitalization standards and management expertise in diversified activities.

In summary, Sears supports the approach taken by Chairman Garn and Members of this Committee to address comprehensive financial services legislation. Any other approaches, particularly those aimed purely at closing loopholes, imposing moratoriums, or failing to address the real issues will harm more than help the industry.

Sears appreciates the opportunity to present its views to this Committee.

The CHAIRMAN. Thank you, Mr. Telling.
Mr. Shipley.

STATEMENT OF WALTER V. SHIPLEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHEMICAL NEW YORK CORP. AND CHEMICAL BANK

Mr. SHIPLEY. Mr. Chairman, and members of the committee, I appreciate the opportunity to discuss the need for Senate action to move us toward a more stable and competitive financial services system in the United States.

My message today is straightforward. The time has come for Congress to provide the legislative framework to lead us from an outmoded and cumbersome banking structure to one that is more stable, more competitive, and more efficient. A structure where consumers of banking services will be the beneficiaries. I believe this can be brought about by lifting geographic constraints on interstate banking and by allowing banks greater freedom to become more effective intermediators of funds flows in the economy. These changes imply greater trust by all of us in the power of the marketplace than has traditionally been the case.

LABORING UNDER LEGACIES OF PROTECTIONISM

For any industry but banking, these are hardly radical principles. The U.S. banking system, however, is laboring under four legacies of protectionism. These are the legacies of: Geographic protectionism; product and functional protectionism; quality protectionism, and price protectionism.

These four legacies have not only distorted normal market forces, but also, over time, have distorted the U.S. banking system itself. Allowing market forces to correct these accumulated distortions will prove painful in the short run, but a pain worth the price in the long run, as a stronger, sounder, more efficient system emerges.

Of the four legacies I've described, geographic protectionism has been particularly harmful. The Framers of the Constitution of the United States recognized the importance of free interstate commerce and prohibited trade barriers among States or regions of the Nation. Yet we allowed interstate barriers to become commonplace in banking, and today State legislatures throughout the country are being asked to create new regional banking compacts. I cannot understand the logic of a New England banking region, or a Southeast banking region, when we otherwise permit the free flow of goods and services throughout the country.

Consider the folly of the present structure. Chemical Bank, because it is based in New York, cannot serve me in New Jersey, where I live. If a New Yorker retires to a Sun Belt State, he must consider breaking a banking relationship that may go back 50 years, simply because he is moving to a different part of the country. I expect you all maintain at least two banking relationships solely for geographic reasons—one in your home State and one here in this area.

Wouldn't it be preferable to have a national policy that moves us toward full interstate banking? This would also recognize that the

electronics and communications revolution will soon make it possible for borrowers and depositors alike to seek better values in financial services, irrespective of geography. If, at home or in the office, I can use my desktop computer to shop for the best interest rates, I am hardly going to be constrained by the Douglas amendment or the McFadden Act.

The marketing reasons for ending the legacy of geographic protectionism seem to me to be powerful. But a more urgent reason for ending protectionism is found in the need for improving the soundness, security, and efficiency of the American banking system.

The ban against interstate banking inhibits banks from diversifying risks in their loan and deposit portfolios, a primary tenet of good banking practice. Smaller banks, especially, are likely to concentrate loans in the industries of their particular region.

The greatest penalty our Nation is paying for the present structure is the inefficiency of a banking system built by 14,800 separately incorporated banks. A system with 14,800 bank chairmen, computer systems, personnel departments, and so forth. The Canadian system, on the other hand, was created as a nationwide system. It is significantly more efficient than ours, due to the economies of scale they have been able to achieve. If U.S. banks could consolidate and, over time, cut costs to reach the same ratio of operating expense to assets as Canadian banks have achieved, they would save some \$21 billion per year, or 25 percent more than the entire U.S. banking industry's after-tax profit in 1983. It seems to me that this is a goal no one can debate.

This brings me to the subject of the second legacy, that of product and functional protectionism.

Commercial banking, quote, unquote, includes a defined range of products and services. Banks are not permitted to offer related financial services outside the scope of that definition. On the other hand, we have had a protected marketplace that others have not been allowed to encroach upon.

TIME TO CHANGE THE RULES

I believe it is time to change the rules. The consumer today no longer differentiates between investments and deposits, except for small working balances in checking accounts. Does it make sense today for Chemical Bank to be able to offer a money market deposit account but not a money market fund account or visa versa for Merrill Lynch.

When a corporation has short-term borrowing needs does it make sense for Chemical Bank to be able to lend our depositors' money to that corporation but not to be able to underwrite and distribute that loan directly to our depositors in the form of commercial paper? I don't think so.

I recognize, and am prepared to accept, that as a result Chemical will have a host of new competitors in its traditional markets. But we are prepared to accept additional competition if we are given the opportunity to serve new markets in return.

The third artificial legacy is that of quality protectionism. Banks are not all equally well-managed; otherwise we wouldn't have bank

failures. But Federal deposit insurance protection has created an artificial equality of quality. All banks, no matter how well or poorly managed, become equal under a Federal protective umbrella. I am certainly not arguing for the abolition of Federal deposit insurance, which is an important cornerstone of our banking system. But, because of the umbrella of protection provided by FDIC insurance, consumers have no need to pay attention to the quality differences among banks and, as a result, such differences are much greater than if banks had been exposed to market discipline, year in and year out.

As you grapple with the question of how to strengthen the system, it will be important to find ways to recognize these quality differences without making self-fulfilling prophecies. And I suspect that as long as we are dealing with 14-plus separate institutions, we will continue to be frustrated with the weakness in the supervisory role of the various regulators. In my opinion we have too many banks for the present system of examination to work well.

The fourth and final legacy is that of price protectionism.

Until recently, there were controls on the interest rates we could pay our customers on deposits. The cost structure of our banking system was built on the artificial economics of being able to rely upon free or low-rate deposits, gathered from consumers, as a source of funds.

That price protectionism has all but disappeared, but the effects of deregulating interest rates will be felt for some time to come. At Chemical, for example, less than 17 percent of our funds now come from demand, or below market rate, deposits. This is typical for money center banks but not for smaller institutions. As more and more funds shift to market rates, the loss of this protective umbrella will be felt by those smaller banks in particular.

To offset higher cost we have seen that some banks have resorted to reaching on the asset side of the balance sheet, adopting riskier lending practices for higher returns.

We have a banking system with an uneconomic cost structure, created under old protectionist rules. The market strains we are now experiencing are the result of an adjustment process. But the alternative of continuing price protectionism would have been worse, because it would have postponed the day of reckoning and made the adjustment process even more painful.

I believe Congress is to be congratulated on the way it recognized the longer term benefits of price competition and drafted the legislation that implemented change. It was clear that price deregulation had to be undertaken with care. Not every adjustment problem could be anticipated, and therefore provided for in legislation. Flexibility, based upon experience and commonsense, was essential. Congress created the Depository Institutions Deregulatory Committee [DIDC] and it has worked extremely well.

I am here today to advocate strongly a similar approach to geographic and product deregulation. My recommendation is that Congress create a committee similar to DIDC to implement this deregulation. It should be given the power, within clearly defined parameters set by Congress. To implement the orderly phaseout of barriers to interstate banking and the ultimate elimination of such restrictions, and the dismantling of barriers to product competition.

The U.S. banking system must be allowed to change, and to adapt to market conditions, if it is to remain strong, stable, and competitive. Artificially imposed constraints on the industry are threatening its viability. Without clear direction from Congress, deregulation is taking place in an unorganized way through loopholes. A sensible, planned approach to change is essential if confidence is to be maintained in the system.

Thank you.

[The complete prepared statement follows:]

Mr. Chairman and Honorable Members of the Committee:

My name is Walter Shipley. I am chairman and chief executive officer of Chemical New York Corporation and Chemical Bank. I appreciate the opportunity to discuss the need for Senate action to move us toward a more stable and competitive banking system in the United States.

My message today is straightforward. The time has come for Congress to provide the legislative framework to lead us from an outmoded and cumbersome banking structure to one that is more stable, more competitive, and more efficient. A structure where consumers of banking services will be the beneficiaries. I believe this can be brought about by lifting geographic constraints on interstate banking and by allowing banks greater freedom to become more effective intermediators of funds flows in the economy. These changes imply greater trust by all of us in the power of the marketplace than has traditionally been the case.

For any industry but banking, these are hardly radical principles. The U.S. banking system, however, is laboring under four legacies of protectionism. These are the legacies of:

- Geographic protectionism
- Product and functional protectionism
- Quality protectionism, and
- Price protectionism.

These four legacies have not only distorted normal market forces, but also, over time, have distorted the U.S. banking system itself. Allowing market forces to correct these accumulated distortions will prove painful in the short run, but a pain worth the price in the long run, as a stronger, sounder, more efficient system emerges.

Geographic Protectionism

Of the four legacies I've described, geographic protectionism has been particularly harmful. The framers of the Constitution of the United States recognized the importance of free interstate commerce and prohibited tariff or other trade barriers among states or regions of the nation. Yet we allowed interstate barriers to become commonplace in banking, and today state legislatures throughout the country are being asked to create new regional banking compacts. I cannot understand the logic of a New England banking region, or a southeast banking region, when we otherwise permit the free flow of goods and services throughout

the country. What if we confined airlines to serving a particular region of the country? Or if New Englanders could import fruits and vegetables from Mediterranean Europe more easily than from states of the Sun Belt? What if Chicagoans had to pay a tariff for purchase of petroleum produced in Texas?

Consider the folly of the present structure. Chemical Bank, because it is based in New York, cannot serve me in New Jersey, where I live. If a New Yorker retires to a Sun Belt state, he must consider breaking a banking relationship that may go back 50 years, simply because he is moving to a different part of the country. I expect you, as U.S. Senators, maintain at least two banking relationships solely for geographic reasons -- one in your home state and one in the Washington area. If you reside in Maryland or Virginia, you may need three different banks.

Wouldn't it be preferable to have a national policy that moves us toward full interstate banking? This would also recognize that the electronics and communications revolution will soon make it possible for borrowers and depositors alike to seek better values in financial services, irrespective of geography. If, at home or in the office, I can use my desktop computer to shop for the best interest rates, I am hardly going to be constrained by the Douglas Amendment or the McFadden Act.

Geographic Diversification and Soundness

The marketing reasons for ending the legacy of geographic protectionism seem to me to be powerful. But an urgent reason for ending protectionism is found in the need for improving the soundness, security, and efficiency of the American banking system.

The ban against interstate banking inhibits banks from diversifying risks in their loan and deposit portfolios, a primary tenet of good banking practice. Smaller banks, especially, are likely to concentrate loans in the industries of their particular region. In 1984 there were 79 bank failures, more than any year since the 1930s. The downturn in energy, agriculture, and in some areas, real estate, contributed to the failure of many of these banks.

The greatest penalty our nation is paying for the present structure is the inefficiency of a banking system built by 14,800 separately incorporated banks. A system with 14,800 bank chairmen! Computer systems. Personnel departments. Et cetera. The Canadian system was created as a nationwide system. It is a significantly more efficient system than ours, due to the efficiencies and economies of scale they have been able to achieve. A comparison between the U.S. and Canadian systems demonstrates the kind of savings that consolidation could make possible. If U.S. banks could

consolidate and, over time, cut costs to reach the same ratio of operating expense to assets as Canadian banks have achieved, they would save some \$21 billion per year, or 25 percent more than the entire U.S. banking industry's after-tax profit in 1983. It seems to me that this is a goal no one can debate. The result would benefit the consumer in the form of lower cost, and the system as a whole by enabling banks to build their capital positions more rapidly.

Product Protectionism

This brings me to the subject of the second legacy, that of product and functional protectionism.

"Commercial banking," quote, unquote, includes a defined range of products and services. Banks are not permitted to offer related financial services outside the scope of that definition. On the other hand, we have had a protected marketplace that others have not been allowed to encroach upon.

I believe it is time to change the rules. The consumer today no longer differentiates between investments and deposits, except for small working balances in checking accounts. Does it make sense today for Chemical Bank to be able to offer a Money Market Deposit Account but not a Money Market Fund Account or for Merrill Lynch to be able to offer a Money Market

Fund Account but not a Money Market Deposit Account? I don't think so.

When a corporation has short-term borrowing needs does it make sense for Chemical Bank to be able to lend our depositors money to that corporation but not to be able to underwrite and distribute that loan directly to our depositors in the form of commercial paper? I don't think so.

New products are being developed at an extremely rapid pace and that is healthy. And it is unlikely that regulations can be created fast enough to prohibit such product innovations, so long as they serve market needs. But wouldn't it be better if Congress played a positive role by freeing banks to serve the evolving needs of the marketplace?

I recognize, and I am prepared to accept, that as a result Chemical will have a host of new competitors in its traditional markets. But we are prepared to accept additional competition if we are given the opportunity to serve new markets in return.

Quality Protectionism

The third artificial legacy is that of quality protectionism. Banks are not all equally well-managed; otherwise we wouldn't have bank failures. But Federal deposit insurance protection has created an artificial

"equality of quality." All banks, no matter how well or poorly managed, become equal under a Federal protective umbrella. I am certainly not arguing for the abolition of Federal deposit insurance, which is an important cornerstone of our banking system. But, because of the umbrella of protection provided by FDIC insurance, consumers have no need to pay attention to the quality differences among banks and, as a result, such differences are much greater than if banks had been exposed to market discipline, year in and year out.

As you grapple with the question of how to strengthen the system, it will be important to find ways to recognize these quality differences without making self-fulfilling prophecies. And I suspect that as long as we are dealing with 14,000-plus separate institutions, we will continue to be frustrated with the weaknesses in the supervisory role of the various regulators. In my opinion we have too many banks for the present system to work well.

Price Protectionism

The fourth and final legacy is that of price protectionism.

Until recently, there were controls on the interest rates we could pay our customers on deposits. The cost structure of our banking system, involving bricks,

mortar, and extensive branch systems, was built on the artificial economics of being able to rely upon free or low rate deposits, gathered from consumers, as a source of funds.

That price protectionism has all but disappeared. But the effects of deregulating interest rates will be felt for some time to come. At Chemical, for example, less than 17 percent of our funds now come from demand or below market rate deposits. This is typical for money center banks but not for smaller institutions. As more and more funds shift to market rates, the loss of this protective umbrella will be felt by those smaller banks in particular.

To offset higher cost we have seen that some banks have resorted to reaching on the asset side of the balance sheet, adopting riskier lending practices for higher returns.

We have a banking system with an uneconomic cost structure, created under old protectionist rules. The market strains we are now experiencing are the result of an adjustment process, and there will continue to be forced or assisted mergers among banks that are unable to compete in an unprotected environment. But the alternative of continuing price protectionism would have been worse, because it would have postponed the day of reckoning and made the adjustment process even more painful.

I believe Congress is to be congratulated on the way you recognized the longer-term benefits of price competition and drafted the legislation that implemented change. It was clear that price deregulation had to be undertaken with care. Not every adjustment problem could be anticipated, and therefore provided for in legislation. Flexibility, based upon experience and common sense, was essential. You created the Depository Institutions Deregulation Committee (DIDC) and it has worked extremely well.

Committee for Geographic and Product Deregulation

I am here today to advocate strongly a similar approach to geographic and product deregulation in the banking industry. My recommendation is that Congress create a committee similar to DIDC to implement this deregulation. It should be nonpartisan, composed of senior officials from the Treasury, the Federal Reserve, the FDIC, the Comptroller's office, and the Conference of State Bank Supervisors. The committee should be given the power, within parameters set by Congress, to implement the orderly phase out of barriers to interstate banking and the ultimate elimination of such restrictions, and the dismantling of barriers to product competition. The issues are extremely complex and this process removes the details, appropriately I believe, from political pressure.

The Need for Action Now

The U.S. banking system must be allowed to change, and to adapt to market conditions, if it is to remain strong, stable, and competitive. Artificially-imposed constraints on the industry are threatening its viability. Without clear direction from Congress, deregulation is taking place in an unorganized way through loopholes. A sensible, planned approach to change is essential if confidence is to be maintained in the banking system.

Thank you.

The CHAIRMAN. Thank you, Mr. Shipley.
Mr. Caspersen.

STATEMENT OF FINN M.W. CASPERSEN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF BENEFICIAL CORP.

Mr. CASPERSEN. Thank you, Mr. Chairman.

Mr. Chairman, members of the Banking Committee, I think the makeup of this panel and the two invitees who could not make it today best shows the state of the financial services industry in this country. You have two banks, you have two major insurance companies, you have a merchandiser, you have a consumer finance company. If they had attended, you would have had a securities broker. You would have had a former travel agent.

PROVIDED SERVICES THAT CONSUMERS WANTED

These companies did not get there by virtue of a protected niche, by virtue of concentration of economic power. They got here because they provided a service. They provided a service that the consumer voted for. They have competition. They have a tremendous amount of competition. Indeed, we have heard 14,000 commercial banks. If you take all of the financial institutions, you have 35,000 in this country. There is competition.

But more importantly, there is ability by these organizations to provide the services that the consumer wants and requires.

My company, Beneficial, started in a different way than the others represented. In the first part of the century we were a small loan lender. The average was \$25, \$50, \$100. As the consumer changed, we had to change. We are now a dominant force in second mortgages. We make first mortgages. We are a dominant force in Visa and MasterCard. We are the largest independent consumer finance company in the country.

We changed because we had to, because the competition forced us to. If we had not, we would not be here. A decade or two ago, our average charge was almost 2 percent a month. We have

dropped it now by over 35 percent. At the same time, the cost of funds to us, the interest rates we pay, has gone up 300 percent.

Why did this happen? It happened because if we didn't do it we would not have survived. It happened because these gentlemen up here compete with us. It happened because a former travel company decided they wanted to get into our business.

Who benefited from that? Not us. It was much easier making loans with margins of 25 percent, I guarantee you. But it's the consumer who benefited, and the consumer benefited because of competition. I think that's the key thing that we have got to understand. We must have competition.

As each of you on this committee has heard repeatedly, we have a real revolution in the manner in which consumer financing services are delivered in recent years. Computers and communications technology combined with deregulation have permitted development of many competitive financial services as I have mentioned.

CONSUMER HAS BENEFITED FROM DEREGULATION

The consumer repeatedly has benefited from this deregulation. There has been a decline in interest rates to the consumer and a continuing innovation and expansion of financial services. The key reason for this is the technology and the competition. The technology which helps makes these products available and reduces the cost of financial services to the consumer. Satellite communications, computer networks, ATM systems, credit card systems, and all the rest.

It is absolutely essential to understand that this technology is not a respecter of political, geographical, or institutional boundaries. These trends and the urge and ability to innovate which a deregulated environment encourages must be fostered and nurtured.

The real question today is the same question of June 1983, whether we should recognize the benefits to the consumer and the economy when institutions such as Beneficial engage in consumer banking and encourage such continued involvement or, instead, attempt to turn the clock back and impose new restraints on the delivery of consumer financial services.

Our position is simple. The competitive and innovative developments of consumer banking which are occurring are positive and should be encouraged instead of restricted. Consumer banks should be permitted to operate as they do now whether under new family bank or consumer bank legislation or under existing laws.

If we look at the reasons put forth by those who urge turning back the clock, they frankly have little substance. Briefly put, their argument is that the consumer bank threatens the safety and soundness of the banking system and under certain circumstances will lead to dangerous concentration of economic power. This was the concern in 1983 as well and I am happy to say that in 1985 we have seen no evidence of any safety or soundness problems nor have we seen any such concentrations of power.

To be sure, there have been problems, but I think that close examination of those problems clearly indicates that they have nothing to do with consumer banking questions.

Consumer banking continues to be among the safest and most stable banking entities in the business. That was true in 1983 and there's nothing that has happened since then.

There is, moreover, no evidence to indicate the existence of limited purpose banks generally as leading to any such concentration of economic power. In fact, there has been a growth in smaller banks, as a recent study has indicated. There are hundreds of entrants waiting to enter this business because the banking business, the money business, is the most fungible and has the least barriers to enter.

I believe competition will only continue to increase if nationwide consumer banking is allowed. To repeat what I said in June 1983, to prohibit the entry of new competitive entities into the consumer banking field, thus limiting the benefits to consumers and the economy that can be expected from that competition, is unnecessary, unwarranted, and unproductive. We welcome the competition from Sears and the other members of this panel. We welcome continued competition from the traditional competitors.

Competition is what leads to lowering of price. It's what leads to innovation. We see no reason to limit it.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

Statement of Finn M W Caspersen
Chairman of the Board
and
Chief Executive Officer
of
Beneficial Corporation

Before the
Senate Banking, Housing and Urban Affairs Committee

May 15, 1985

Mr. Chairman, members of the Senate Banking Committee,
my name is Finn Caspersen.

I am Chairman of the Board and Chief Executive Officer
of Beneficial Corporation, the nation's largest independent
consumer financial services company.

We are a company with over \$7 billion in assets, and we
are the largest originator of second mortgages in the
country with \$2.6 billion in mortgage loans outstanding.

We have about 2 million customers with mortgages,
personal loans, sales finance contracts and bank credit
cards, and we have major credit insurance companies with
over \$7.4 billion insurance in force.

Our standard Visa and Mastercard program, operated through our limited purpose bank in Wilmington, Delaware was the 14th largest in the country at the end of 1983, and we expect 1984's figures will raise that to about 10th place. We are also one of the largest issuers of premium Visa and Mastercards in the country.

Through our credit card programs, we extended over \$1 billion in credit in 1984 at rates the consumer found competitive and attractive and in operating all of our programs, our goal is to provide cost-efficient financial services consumers want and need by using the best technology available.

As each of you on this Committee has heard repeatedly, we have seen a real revolution in the manner in which financial services are delivered in this country in recent years, and this revolution is continuing.

Computers and communications technology, combined with deregulation at the federal and state level, have permitted the development of many competitive financial service products, with definite benefits for consumers.

Fifteen or twenty years ago, however, the law permitted only very specific types of personal loans; revolving credit was generally not permissible and rates were strictly controlled.

And, in those days of extremely heavy regulation, the rates companies engaged exclusively in the loan business charged for personal loans averaged in the range of 2 1/2 percent per month and even higher.

Since then, and particularly in the last nine or ten years, most interest rates for consumer credit have been deregulated, the types of loans permitted have been expanded to include second mortgages, credit cards, personal lines of credit and revolving charge accounts, and others, and we have had major changes in the technology that we use to operate our business.

Who has benefited from this deregulation and technological innovation? The consumer has clearly benefited, and a review of interest rate trends is quite illustrative of the benefits of deregulation and technological development. Average rates on our loans, for example, have fallen consistently, and now are about 1.66% per month - under 20% on an annual basis. This is about a 33% decline in rates to the consumer over a period of years when our cost of funds, the interest rate charged to us, has gone up almost 300%.

Also, instead of simply offering a small personal loan for a short fixed term, the consumer now has the benefit of being able to select the best product from among many offered by numerous competitors. We - along with others - now offer revolving, unsecured or real estate-secured loans, credit cards, large loans, line of credit loans with checks and other products.

One key point to keep in mind - the technology which helps make these products available and reduces the delivery cost of financial services to the consumer - satellite communication, computer networks, ATM systems, credit card systems, and all the rest - is not a respecter of political, geographical or institutional boundaries.

These trends and the urge and ability to innovate which a deregulated environment encourages, should be fostered and nurtured although certain of our competitors argue otherwise.

The real question today, as it was in June of 1983 - when I last testified before this committee - is whether we should recognize the benefits to the consumer and the economy when institutions such as Beneficial engage in consumer banking and encourage such continued involvement or instead attempt to turn the clock back and impose new restraints on the delivery of consumer financial services.

Our position is simple - the competitive and innovative developments in consumer banking which are occurring are positive and should be encouraged instead of restricted. Consumer banks should be permitted to operate as they do now, whether under new "consumer bank" legislation, or under existing laws.

If we look at the reasons put forth by those who urge turning back the clock, they have little substance. Briefly put, the argument is that the consumer bank threatens the safety and soundness of the banking system, and under certain circumstances will lead to dangerous concentrations of economic power.

This seemed to be the concern in 1983 as well, and I am happy to say that in 1985 - two years later - we have seen no evidence of any safety and soundness problems nor have we seen any such concentrations of power.

To be sure, there have been some highly publicized banking problems since Penn Square and Continental Illinois which were the topics of discussion in 1983 - I note, for example, the Butcher banking group problems, and the collapse of Home State Savings and Loan in Ohio.

But, as with the earlier problems, none of these more recent incidents, including Home State, has resulted from an institution's involvement in the consumer banking business.

The problems at Home State apparently stem from an attempt to substitute repurchase agreements for traditional products in order to achieve extremely rapid growth in assets, in a less than prudent manner and, to the best of my knowledge, the other bank and thrift failures often cited have resulted from mismanagement (or worse), from foreign loan problems, from energy-related lending, or from commercial loan problems.

There simply is no substance to the concerns usually expressed. Consumer banks continue to be among the safest and most stable banking entities in the business. That was my opinion in 1983, and nothing has happened in the nearly two years since to change that opinion.

There is, moreover, no evidence to indicate the existence of limited purpose banks, generally, is leading to any economic concentration of power. To the contrary, there are hundreds of entrants waiting to enter this business, and I believe competition will only continue to increase if nationwide consumer banking continues to be permissible.

To repeat what I said in June of 1983 - to prohibit the entry of new competitive entities into the consumer banking field, thus limiting the benefits to consumers and the economy that can be expected from that competition, is unnecessary, unwarranted and unproductive.

We welcome the competition from Sears, which has announced a new nationwide credit card to compete with our bank credit card program, and from others who can innovate and provide market leadership. We have been market leaders in mortgages and in revolving credit, going back 70 years, and we have been involved in consumer banking for more than 30. We believe in competition, and believe a healthy consumer financial services market is one way of assuring the continued great economic success this country has enjoyed in the past.

Innovation in a deregulated environment is healthy and should be permitted to continue. We are ready to provide better and cheaper services to the consumer so we can continue to grow and prosper with America. We see no reason to reverse current positive trends at this time.

Thank you. I will be happy to answer any questions.

The CHAIRMAN. Thank you.
Mr. McElwee.

**STATEMENT OF JOHN G. McELWEE, CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER, JOHN HANCOCK MUTUAL
LIFE INSURANCE CO.**

[The complete prepared statement follows:]

Mr. Chairman and members of the Committee, my name is John G. McElwee, Chairman of the Board and Chief Executive Officer of John Hancock Mutual Life Insurance Company. I appreciate the opportunity to express our views on legislative proposals involving financial services.

I start from the premise that the financial services revolution we are witnessing has taken place in spite of and not because of the regulatory structure; and, that this Committee and the Congress want to address the issues raised by this revolution by developing a regulatory structure that:

- Responds to the needs of the public;
- Fosters individual savings and the formation of capital; and
- Affords all financial institutions equal opportunity to serve the credit and financial needs of consumers.

John Hancock wants to help these things happen and to be a positive presence in this effort. In a more parochial sense, we want to be sure that companies such as ours have a fair and equal chance to participate. More specifically, just as banks seek expanded insurance functions, we seek certain banking functions.

The existence of the diversified financial services provider is already a reality - not a prospective development.

The broad range provider has emerged not simply because it can provide benefits the public wants but also because affordable technology exists to make it work. You have heard many times who those providers are. I need not run the litany of that roster.

It is pointless to attempt to stop this thrust by limited amendments or the closing of loopholes in a regulatory structure designed for the economic, social and political conditions of a by-gone era. The genie cannot be stuffed back into the bottle any more than the increased sophistication of the public can be reversed or the technological developments in data collection and transmission can be erased from our experience.

John Hancock believes that the present regulatory philosophy must be thoroughly reviewed and revised. This Committee has begun that process. Senate Bill 2851 which was passed by the Senate last year focused on expanding the powers of banks to engage in activities other than banking. That the bill should have had this focus is understandable. Banks have effectively articulated their legislative concerns and their contributions to the nation's economy are well known to this Committee and to the Congress generally. It is understandable that the interests and needs of these federally regulated institutions would be meaningfully addressed by the Congress, the Treasury, the Federal Reserve Board, the Comptroller of the Currency and the FDIC.

The interests and needs of state regulated insurance companies are less familiar to this Committee and to agencies of the federal government. Up to this point, the life insurance industry, and mutual companies especially, have not done an adequate job of making their role and their unique situation understood. After more than a hundred and fifty years of service, our industry has come to a position where we now provide protection to over 160 million people and have provided a national pool of capital on the order of \$700 billion. We think that record justifies a request for reciprocity with banks and other competitors. We do not seek special treatment or opportunity. We seek equal treatment.

No longer is the manufacture or distribution of any one financial service or product the exclusive domain of any one segment of the industry. At John Hancock we see a future in which several product and service specialists within a financial services complex can satisfy the great majority of a consumer's financial needs. In planning our future, we come back repeatedly to our sales organization which is one of our strongest assets. Our agents are highly motivated and trained, and are supported by strong marketing services. But most important, they are loyal and come out of a long tradition which cannot be duplicated, assembled or readily acquired.

John Hancock thinks that you and I and all other consumers should be free to purchase financial services from the broadest range of competing organizations. Present regulations and proposals prevent this. It is vital to the national economy that changes in the competitive balance among banks, insurers, securities firms and other financial services providers not diminish the ability of any segment, however regulated, to continue to compete fully in the marketplace. To provide anything less than full reciprocity will concentrate the provision of financial services in selected segments and foreclose competition by other providers. The life insurance industry cannot help but lose market share if it is denied equal market access. It is imperative that any federal proposal be premised on reciprocal market access so that all financial services providers may participate equally in the marketplace.

Reciprocal market access cannot, however, be achieved unless the legislative proposals of this Committee embrace a full understanding of the unique nature of mutual life insurance companies. To overlook this corporate form is to inadvertently cripple a portion of the industry which represents 56% of life insurance company assets. I make this point because the proposals which have been presented to you by the Treasury and others presuppose that diversification for all

financial services providers can be accomplished through an upstream parent holding company. This simply is not so for a mutual life insurance company.

A mutual life insurance company is held by its policyholders and has no stock. It is impossible for a mutual life insurer to form an upstream holding company. Accordingly, proposals for financial services diversification which require, as a structural prerequisite, the formation of an upstream holding company effectively preclude mutual life insurance companies from full participation in the financial services markets.

In the several discussions we have had with members of the Congress and of the Administration about the unique nature of mutual companies, one immediate suggestion has been: "Convert to a stock company, and then create an upstream holding company." We wish it were so simple! Even if conversion were possible, it could not occur for most mutual life companies until long after other diversified financial services institutions had captured the market.

There are two different philosophies of diversification. State insurance regulation has long allowed insurance companies to diversify through downstream subsidiaries. For mutual companies that is the only means of diversification. On the

other hand, federal regulation is premised on the utilization of an upstream holding company. We see no reason why financial services diversification must be based on the concept of an upstream holding company.

We agree with those who advocate a system of regulation where different financial products and services are offered through separate but affiliated companies. Under such an approach, each sector of the financial services market - banking, life insurance, securities brokerage, etc. - is regulated separately. Each separate subsidiary or affiliated company would be subject to the appropriate regulatory body having jurisdiction over the function being performed by that particular company, whether it be a bank, an insurer or a securities broker.

Not every stock or mutual life insurance company will want to diversify nor should they be obliged to. Those companies, because of their size, market niche, or other considerations, may elect to remain specialized insurance providers. They should be free to do so. At John Hancock we feel there is no option but to diversify because of the nature of our markets. For the last 20 years we, along with other large life insurers, have been losing market share. Diversified financial providers with banking powers are increasingly able to invade our markets. Unless life companies are also granted banking authority, the erosion will continue.

To us at John Hancock, it doesn't seem like reasonable public policy to let a major industry dry up slowly because it cannot compete on equal terms. Yet, that is exactly where present policy appears to be heading today with respect to life insurance because of regulatory barriers. If we are to compete in the emerging financial services marketplace - and we believe we should have every right to do so - and if we are to hold ourselves out to consumers as a diversified financial services organization, then we must offer banking services...as well as insurance services and securities brokerage services and credit card services and real estate services and all the rest. It's just as simple as that.

Our efforts to diversify have, however, made us acutely sensitive to state and federal regulatory barriers preventing our full participation in this marketplace. While federal law and regulations applicable to banks and securities firms can be changed by a single act of Congress, the situation for state regulated insurance companies is very different. Insurance companies licensed in a number of states confront not only the necessity of securing appropriate enabling legislation in their state of domicile, but also complying with the laws of all other states in which they do business. The regulatory pattern is far from uniform among the states. The fact that a company domiciled in, say, Massachusetts may be granted authority to

provide a number of financial services through various subsidiaries does not mean that it can implement that authorization uniformly in all states.

Such unnecessary regulatory conflicts could be avoided by providing insurance companies with the option of a federal insurance charter. This optional system would accommodate life insurance companies electing to diversify as well as those electing to remain specialized insurance providers. This is analogous to the system of bank regulation in this country. Federal and state banks have long operated under the dual system of bank regulation. Insurance companies should have a similar option. Those wishing to engage in a broad range of financial services could elect to be federally chartered. Those wishing to remain primarily insurance providers need not change. Such a system could accommodate the unique situation of mutual life insurance companies and remove the impediment of crippling state law variations.

If Congress chooses not to authorize a preemptive system of federal insurance charters, it must at a minimum acknowledge that there are and will continue to be conflicting state laws which restrict insurance company diversification. Unless Congress addresses this problem, it will not have given the life insurance industry equal market access.

In closing, we believe that the regulation of this new marketplace must be fair and equitable to all and must, at a minimum, include:

- reciprocal market access for all providers;
- regulation by function;
- federal preemption of conflicting state insurance laws; and
- accommodation of the mutual form of organization.

Certainly the present circumstances are most unsettling for everyone. Many interested parties including consumer groups, elected officials and financial executives are either frustrated or despairing of current conditions -- They feel we have opened a Pandora's box and released a multitude of plagues and afflictions. ... It is worth remembering that in one version of the story there remained in Pandora's box one shining virtue -- that was Hope. ... Hope we still have and we have more ... we have opportunity. ... You have the opportunity and the authority to propose a rational and positive solution. ... I hope you will give John Hancock the opportunity to help in that effort.

BRIEF HISTORY OF FINANCIAL SERVICES INDUSTRY

The CHAIRMAN. Thank you. Gentlemen, I appreciate your testimony today, although I listen to it with a great sense of frustration, and the reason I do is because—well, Mr. Budd makes a comment about how these need to be issues very carefully considered and thoughtfully considered before we rush into anything. I arrived here 10½ years ago and I sat way over there in that last chair. Tom McIntyre, a Democratic Senator from New Hampshire, sat over here and I can remember him talking about the vast changes that were occurring in the financial services industry and how Congress needed to get away from emergency pieces of legislation, moratoriums, 90-day extensions, and start making some overall comprehensive policy decisions. I agreed with my colleague, Tom. I thought he was right and he sponsored the Financial Institutions Act that passed the Senate in both 1975 and 1976 and never saw the light of day in the House.

Now these are not new issues. I certainly did not originate them as chairman of the Banking Committee. They were here before I became a Senator, let alone before I became chairman, but I felt that Tom was ahead of this committee at the time and he was absolutely right that those changes were starting to occur.

Yet even 5 years later when I became chairman and started talking about the financial services revolution all over this country a lot of people said just leave it alone, everything is fine. That has been the general attitude in the House, that loophole closures and moratoriums are fine.

So, the frustration comes from some of you who have testified many times but essentially the same testimony has been going on for decades and Congress has been unwilling to act in a comprehensive fashion.

For 5 years I have been trying to direct not a particular solution or impose any particular ideas of mine on how I think the financial services industry should be organized except to try and convince this committee and this Senate and this Congress that we ought to make some policy decisions rather than just a couple of loophole closures.

As I listened to you today, competitors, a few years ago none of you would have really been here because you weren't competitors yet. It was only the beginnings of the revolution that was occurring, but you are, and that is the reality of the marketplace and it will continue and in a general sense I just don't know quite how to get 535 people, regardless of their difference of opinions on individual issues, to recognize the general problem and do something about it.

It's fortunate that I'm already bald. I don't have to tear my hair out in frustration. But you do just once again bring out the fact that there are vast and dynamic changes going on out there which Congress is unwilling to respond to in any way whatsoever, and particularly in the House.

My first employer after getting out of the Navy as a young naval lieutenant and pilot was with John Hancock, 25 years ago. There is absolutely no comparison between what John Hancock was 25 years ago and what you are doing today, and that is true of every

one of your businesses. You are not doing business the same way you were 5 years ago but you are still being regulated in the same way that you were.

I didn't intend to make a long speech but it just is appalling to me that we can't at least get agreement that some comprehensive legislation is needed rather than saying we've got to continue to study these issues. How long? Another decade?

Mr. Telling you talked about 1983. We did talk about moratoriums and I was opposed then and you remember they wanted a 6-month moratorium just until the end of 1983 because by golly in January 1984 all these opponents would be willing to act and sit down. Well, it's now May 1985. It's been nearly 2 years. What good would a 6-month moratorium have done? I'm hearing the same thing again, well, we've got a busy year, big budget problems, how about January 1986, how about January 2086? I don't know.

CLOSING LOOPHOLES

Anyway, I think it's time we act, whatever that is. I think some decision is better than none, and that's all we're getting out of Congress. And my 6-year-old could write a loophole closure to close the nonbank bank loophole and the South Dakota loophole. That doesn't take any legislative skill or brains to do that. And if we only take that much of a step, all of you have bright attorneys, you will figure out a new loophole next week and I don't condemn you for doing that; you should. Congress is unwilling to make some policy decisions, why not? I would in your situation if I were a chief executive officer of a company, boy, I'd be out there competing and I would look for every legal way to serve my customers and take money away from my competitors that I could. So I encourage you to continue to do that. You should, or you ought to be fired, one or the other.

Mr. Budd, I'm a little bit puzzled by your testimony as one who spent a number of years making my living in the insurance business and your comment about how we ought to federalize all of the banking system.

Does that mean you do not believe in the dual banking system?

Mr. BUDD. I'm not sure I understand your question, Senator, as to federalizing the banking system.

The CHAIRMAN. Well, you were saying that we ought to have regulations that are uniform across the country referring to State-chartered banks. At least that is the way I interpreted your statement. And specifically referring to insurance and undoubtedly the Dodd amendment.

Mr. BUDD. My intent was to say that I did not believe that we should permit loopholes to circumvent what has been the province of the Federal banking system under the provisions of the Bank Holding Company Act.

The CHAIRMAN. Well, I don't disagree with that, but do you think that should extend to State-chartered institutions totally operating within the boundaries of a State or should that be left to State legislatures to determine?

Mr. BUDD. I think it depends on the consequence. If the consequence of allowing the States to extend powers which would permit

large holding companies through chartering, State, by State, by State, to indeed circumvent the Federal Government's ability to implement their responsibilities, then there's a danger there.

The CHAIRMAN. I agree with you on federally chartered institutions. What about the specifics of a State-chartered institution or a bank holding company operating only within the boundaries of that State making no attempt whatsoever to cross State lines?

Mr. BUDD. Unconnected with a national bank holding company?

The CHAIRMAN. A bank holding company, whether national or State with State-chartered branches operating totally within the confines of one State?

Mr. BUDD. If the total entity operates within the confines of one State, I think we have supported that.

The CHAIRMAN. Well, I wish my good friend and colleague from Connecticut did—the Dodd amendment.

Senator DODD. He supported it however.

The CHAIRMAN. You wouldn't be in favor of repealing—I'm going to get you before you get up to date on what's going on.

Senator DODD. I don't have to get up to date to know where you're coming from. [Laughter.]

The CHAIRMAN. I'm just a protector of States rights, Chris.

Mr. BUDD. Senator, just to make sure I understand, you are excluding a State subsidiary of a bank holding company?

The CHAIRMAN. That's correct. You do not feel we should repeal McCarran-Ferguson?

Mr. BUDD. No.

The CHAIRMAN. I don't either, but I also don't believe in double standards. I don't believe the insurance agents of this country should come to this Congress and ask us to get into that narrow area. Federal charters operating across State lines are one thing, but to totally tramp and run roughshod over the rights of State legislatures to make determinations for State-chartered institutions within the boundaries of that State, when they hide behind the McCarran-Ferguson and say we want no Federal regulation on the insurance business, I think that is an incredible double standard and I say that as a former insurance man who is perfectly willing to go fight the Utah State Legislature and tell them that I don't think they ought to authorize State-chartered institutions to sell insurance to work with those individual States. I feel very strongly about this, very strongly about an organization that I made my living in for 10 years, the epitome of the hard-working free-enterprise independent insurance agent who doesn't like Government and says protect me with McCarran-Ferguson and I love my States rights and my State legislature, but good heavens, we don't want banks to sell insurance or we're going to run to Congress and ask them to go beyond Federal charters and Federal regulation and tell each and every State that they must comply.

So I hope that doesn't come back to bite the insurance industry some day and what's good for the goose is good for the gander and we have a movement to repeal McCarran-Ferguson.

Let me just ask you one more question, and then my time is up on this round, but obviously you are opposed to granting additional insurance powers to banks and I understand that. I would be sur-

prised if you took any other position. I'm sure I would if I were in your position.

But at the same time, in your statement you mention that Travelers owns an FDIC-insured bank in Massachusetts and Travelers Capital T Account offers the following service to individuals and small business: Unlimited check-writing privileges, money market interest rates, MasterCard, overdraft privileges, consolidated monthly statements, unsecured lines of credit, and I have no problem with that. I have no problem with that at all. I share the views of many people. Mr. Shipley does. I don't have any problem with insurance companies doing that, except when they then come and tell me, keep banks out of the insurance business. Another double standard.

NO RETURN TO THE OLD WAYS

There's only two ways we can go in this situation. We can tell Sears to get back and sell lawnmowers, sewing machines, furniture, and farm equipment and tell John Hancock and Travelers to sell insurance, tell banks to stay out of everybody else's business, and put it back into nice little compartments they used to be in in the rolltop desk, but that isn't politically possible. You can't put the genie back in the bottle. There's no doubt about it, no matter how much somebody would like to, you can't. So it seems to me the only other alternative is to try—and I hate to use the term but—level up those services to provide some free competition to make some decisions in those areas.

I don't know how it can be both ways. I don't know how the insurance and the securities industry can say keep the banks out of our business. I don't mean to single you out. Please don't misunderstand. You just happen to be here. [Laughter.]

Mr. BUDD. I sort of feel like that.

Senator DODD. And you're not from Utah either.

The CHAIRMAN. You weren't at the first hearing in January 1983, in Utah. I'm much nicer today. We'll get Jim Robinson and the others from Merrill Lynch here. Again, I'm not complaining. I'm not criticizing for you entering into these services and I never have. Nobody has ever heard me say that it was against my political philosophy to allow that kind of competition.

I'm just saying it looks to me like it is unfair if you want to have check writing privileges and MasterCard and all the things that would go with it and own a bank, but a bank isn't supposed to get into your business and into the securities business. That's really what this is all about.

So the testimony of those from the insurance and the securities industry, if you were not dipping your fingers into the banking business, boy, I'd sit here and say you're right, it isn't fair; banks should not be allowed to get into your business. I just don't think it can be both ways. We either close it all up and we go back to somehow magically turn the clock back and put the genie back in the bottle and everybody is doing their specialized service, or we've got to open it up. I really don't see the middle ground or the fairness of that situation.

Now I see you want to reply.

Mr. BUDD. I really do. We certainly are not for rolling back anything either, Senator, and we appreciate this dilemma and believe me the problem you face applies to us in the sense of trying to evolve our strategies in this period of uncertainty.

Let me try to put two things in context. First of all, our opposition to the potential for subsidiaries of bank holding companies getting into our business in a major way State by State through a circumvention process is that that becomes a threat without corresponding action which enables us to do all the things that banks do. It is not a States rights issue with us. It is a question of how that competitive threat can be accomplished at a time when we are not extended, as Jack McElwee said, powers to do the same things in the other direction.

With respect to our involvement in banking-type activities, I think it would have been irresponsible for us in view of the thrust and the strategic announcements that many of our competitors have made not to activate the charter of a company that we had owned since 1969 without doing any banking business and thereby make it possible for us to use that in the event legislation evolves where we need to.

With respect to our black box, which is a cash management kind of activity, we have actually networked that with a banking institution to do the banking functions. So, what we are trying to do is to recognize the trends, be a part of the solution here, and position ourselves with some flexibility. That's different from saying we are trying to have a double standard.

The CHAIRMAN. Well, again, I would agree with you completely. It should not be done by circumvention or loophole in either direction. That's what I've been talking about all these years for Congress to make some decisions so all of you know under what rules you can operate and what you can do. That's why I push regulation by function, because if municipal bonds are going to be sold I really don't care whether it's a bank, or whether it's a securities firm, or an insurance firm, you ought to be regulated in the same manner for that function, not because of what you call yourself, whether you're an insurance company or a bank. So, I don't disagree with you. Circumvention is not the way to go, but that's what's happening in the marketplace both directions, is you—every one of you tries to get into somebody else's business until Congress is willing to make some decisions and that's why simple loophole closures don't solve the problem. We need again to make some policy decisions, whatever those are and whatever consensus we can come to in the Congress rather than the approach that the House wishes to take.

Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Mr. Caspersen, if Beneficial Finance is so intent on offering its customers checking accounts and other banking services, why don't you simply apply for a bank charter and convert your business into a bank?

Mr. CASPERSEN. Senator Proxmire, indeed we do have a limited purpose bank in Delaware and are offering those services at this juncture.

The financial services industry, as everybody at this table will attest to, as I'm sure you've heard many, many, many times, has changed so dramatically that we need access to the payments system in order to properly, efficiently, and effectively serve the consumer. The day when the consumer will go into an office every time they want \$100 or \$200 takedown line of credit is long since over. The consumer wants a piece of plastic that he or she can utilize at his or her discretion at the lowest possible cost. If we are to be competitive and viable, we have to offer them that.

PRIVILEGES NOT AVAILABLE TO BANKS

Senator PROXMIRE. Don't you see the competitive unfairness? The banks are tightly regulated. This is the most heavily regulated industry that we have, and unless Congress is willing to allow banks to engage in all the activities at the nationwide locations that Beneficial is engaged in, how is competitive equity served by giving Beneficial privileges not available to banks or bank holding companies?

Mr. CASPERSEN. Our bank subsidiary is regulated equally with the other bankers at this table by the same regulatory agency with the same safeguards. Indeed, our leverage is less than our banking competitors because we come from a different industry where 5 or 6 to 1 leverage was the accepted norm, not 15 to 20 to 1.

Senator PROXMIRE. But you're not under the Bank Holding Company Act and you're not subject to the restrictions of the Bank Holding Company Act.

Mr. CASPERSEN. We are subject to many of the restrictions. There are certain grandfather clauses, et cetera.

Senator PROXMIRE. But you're not subject to the same restrictions as a bank holding company.

Mr. CASPERSEN. We are a bank holding company; yes, sir.

Senator PROXMIRE. Mr. Preston, I should but I can't avoid saying that I used to work for your company. I'm very proud of that. It's a marvelous company and you have a superb record in the banking industry. There's none better than J.P. Morgan.

If Glass-Steagall were repealed, banks would be allowed to enter the securities business. By the same token, securities firms would be able to engage in banking activities, including the offering of checking accounts and making commercial loans.

Do you favor securities firms such as Merrill Lynch getting into the banking business?

Mr. PRESTON. Senator, I thought they were in it.

Senator PROXMIRE. I mean all the way?

Mr. PRESTON. Certainly, we welcome that.

Senator PROXMIRE. How many of your colleagues in the American Bankers Association would agree with you on that?

Mr. PRESTON. I have no idea.

Senator PROXMIRE. Well, I do. I'll tell you my idea is that you're not alone but you would be in a small minority. Do you disagree with that?

Mr. PRESTON. I don't know how the members of the American Bankers Association feel. I would have thought that it would en-

hance competition and provide an additional service to the consumer and that they would welcome that.

Senator PROXMIRE. Well, perhaps they do. The bankers I talk to—of course, a lot of them are from Wisconsin but some of them are from New York—most of them disagree with that.

Mr. Shipley, do you support the Sears proposal for allowing family banks to operate outside the restriction of the Bank Holding Company Act?

Mr. SHIPLEY. Senator, my position is that we need to find the mutuality of all to compete on a broader scale. To take any one segment and allow—the question you asked Mr. Preston, should Merrill Lynch be allowed in the banking business if the banks are allowed in the securities business—if it is the two that are allowed together, I would support it. I would support also the question you asked about Sears. If they are allowed to be in the community banking or family banking operation on a nationwide basis, then I think that institutions like ours should have the breadth and capacity that they have.

Senator PROXMIRE. You don't really want to get into that Sears business, do you?

Mr. SHIPLEY. Why not?

Senator PROXMIRE. Banking is so much more prestigious.

Mr. SHIPLEY. Chemical Bank—you know where we got our name, don't you?

Senator PROXMIRE. Where?

Mr. SHIPLEY. The New York Chemical Manufacturing Co. in 1824 received a banking charter from the State of New York.

Senator PROXMIRE. How much of your business is chemical today?

Mr. SHIPLEY. Very little.

Senator PROXMIRE. On page 4 of your statement you complain about the alleged inefficiencies of the U.S. banking system compared to the Canadian banking structure. In Canada the top five banks control upwards of 95 percent of the banking business. Is that the type of banking structure you would like to see in the United States?

Mr. SHIPLEY. No; it is not.

Senator PROXMIRE. Well, it seems to me that if we adopted what Canada has and almost every other country except this country has, we would be moving very much in that direction. We have 14,000 banks. I think it's marvelous. I think that's a terrific amount of competition. It's local ownership and it's pluralism in the banking business. It means a little city like Richmond Center can have its own bank locally owned and you don't have that in Canada, or United Kingdom, or Italy, or Japan, or anywhere else in the world. I think that's one of the reasons why our small towns have been able to prosper and continue.

COST OF \$21 BILLION TO CONSUMERS

Mr. SHIPLEY. My testimony shows, however, Senator, that this costs the consumers of the Nation \$21 billion a year and the entire earnings of the banking industry in 1983 after tax were \$15 billion. So it's a huge cost.

Senator PROXMIRE. Well, I'm not so sure that cost is right. Let me challenge that a little bit.

It seems to me that your measure of efficiency is narrowly focused. Most banking studies show that there are no significant economies of scale in banking beyond an asset size of \$500 million. Moreover, you totally ignore the dynamic role of small firms in creating innovative new products and services and jobs in our economy. For example, it was not the big banks that came up with the NOW accounts. It was a relatively small mutual savings bank.

Don't we lose a lot if we encourage more consolidation in banking?

Mr. SHIPLEY. I don't think so. I think for every example of a NOW account, we can produce many other examples of creative products and services introduced by large institutions.

Senator PROXMIRE. Well, the fact is that these other countries that have permitted nationwide banking have enormous concentrations. Can you give me a single exception to that situation where they don't have five, or six, or seven, or eight banks doing 95 percent of the business?

Mr. SHIPLEY. Senator, with respect, you are creating an either/or, either 14,000 or 5, and I'm not advocating 5 nor am I advocating 14,000. But I do believe that a consolidation is essential. The systems that have been created with a broader focus show greater economies of scale and the facts show that those economies are real.

Senator PROXMIRE. How many banks would you advocate would do 95 percent of our business? About 300?

Mr. SHIPLEY. I don't think there is a specific number, but I do believe that 14,000 is entirely too many.

Senator PROXMIRE. 13,000 is better, or 10,000?

Mr. SHIPLEY. Sure. 12,000 is better.

Senator PROXMIRE. Mr. Telling, would Sears support legislation allowing banks or bank holding companies to become retailers?

Mr. TELLING. We would welcome it.

Senator PROXMIRE. You would welcome it?

Mr. TELLING. Welcome it.

Senator PROXMIRE. I can see why. You don't have to worry about that.

Mr. TELLING. I should say, first, I'm glad I'm as old as I am and I'm sitting down here and not there where you are.

Senator PROXMIRE. You're how old?

Mr. TELLING. I'm as old as I am and sitting here and not there. The problem is much easier from this side of the table and I thought when Senator Garn—

Senator PROXMIRE. Well, there are reasons why I would prefer to be sitting on your side of the table. [Laughter.]

Mr. TELLING. We won't pursue that.

Senator PROXMIRE. You make about \$1 million a year.

Mr. BUDD, would you support legislation allowing banks or bank holding companies to enter the insurance business, including insurance underwriting?

Mr. BUDD. Sir, I'm sorry?

Senator PROXMIRE. Would you support legislation allowing banks or bank holding companies to enter the insurance business, including insurance underwriting and vice-versa?

Mr. BUDD. I think we would look at that as to whether the playing field did indeed become level. Also my testimony indicates that we think the financial stresses in both the banking industry and the insurance industry today would indicate that that would not be timely.

Senator PROXMIRE. Mr. McElwee, what is your response to that?

Mr. McELWEE. Yes, sir; I would support it.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I'd like to note a couple of things. You talked about competition, free flow, et cetra, and yet it's this very same Congress and this Senate that voted overwhelmingly to restrict interstate banking. Now that was done on the altar of political expedience. There is not one bona fide reason for saying that banks should not be allowed to have free access from State to State except if we're going to say back home it makes sense to say we don't want the big bad bank from New York coming in, oh, no, keep them out. If we're going to talk about the free flow of capital, then I think we should understand it. There is no recognized authority from the Treasury or from the Fed, including Paul Volcker, who would suggest that this is anything but an arbitrary law, wastefully restricting interstate banking. But again, back home—and I understand the pressures—it is something whereby we can say that we kept the little home town bank from being swallowed up. When we take a look at the failure of Continental Illinois and we ask why did this failure occur? Well, in addition to some poor management, loans, and the failure of the Federal Reserve to move quick enough, the fact is they didn't have a deposit base whereby they could go out and do their job.

UNRESTRICTED INTERSTATE BANKING

Let me ask Mr. Telling, do you believe that we should restrict interstate banking or do you think that it's time to have a free and open marketplace with respect to banking and allow some of the big New York banks to open up branches in Illinois and other places?

Mr. TELLING. Yes; I believe they should.

Senator D'AMATO. Mr. Budd.

Mr. BUDD. Yes; I believe they should.

Senator D'AMATO. Mr. Caspersen, you know, I found it amusing—I wrote a little note here—25 percent interest, not bad, and now you have to get less than 25 percent.

What do you think about that, Mr. Caspersen?

Mr. CASPERSEN. I think there should be free and open competition subject to the safety requirements which can be taken care of by appropriate legislation.

Senator D'AMATO. Mr. McElwee.

Mr. McELWEE. Senator, as long as they are all regulated the same by function, I think there should be the fullest opportunity for everyone.

Senator D'AMATO. And that's why I did everything I could to defeat that legislation. However, it passed 93 to 2.

The CHAIRMAN. It was 89 to 5.

Senator D'AMATO. Oh, 89 to 5.

The CHAIRMAN. You did better than you thought.

Senator D'AMATO. The chairman corrects me. I'm not going to ask Mr. Shipley or Mr. Preston to comment on the interstate banking aspect. Obviously, we understand what their position is.

But I have a problem talking about trying to adjust to the marketplace. I think it's doing a pretty good job. We have all these financial products and services, et cetera. I don't know why we're in such a rush to come up with a legislative package, particularly one that would place the American taxpayer at risk. One of the problems today is that all financial institutions that come into the banking area get some kind of FDIC insurance, regardless of whether or not bank X or bank Y is operating efficiently and effectively. Why, if you're going to undertake a risky activity, a securities activities, should the American taxpayer be called upon to give FDIC insurance? I think there's something inconsistent and wrong. You could say that you're going to set up a separate subsidiary, but if that separate subsidiary runs into trouble it's going to have a resulting effect on the main institution, the banking institution.

Now if you're going to say that you're not going to have FDIC insurance, fine; go to it. But how do you do that? I mean, don't you see any inconsistency?

Mr. SHIPLEY. No, Senator D'Amato, I don't. If you were to expose the same funds without controls and assume that losses in the security industry might become losses to depositors, perhaps you would have a point. But I don't think any of us are suggesting that.

Senator D'AMATO. OK. Mr. Telling, do you have any comment? You follow what I'm saying? If you want to go into the securities industry, fine, everybody should go into it. But why should there be FDIC insurance? I don't believe in that. I think it's going to place the taxpayer at a greater risk. I think in the Continental Illinois situation the Federal Reserve went far beyond what it should have done, but I'm not going to open that up. The securities industry by its very nature is a risky business. I understand you've been in GO's, general obligations, that are far different from some of the other underwritings. Why should the American taxpayer underwrite it? If a securities firm goes out there on its own and makes its money and takes its losses, at least the American taxpayer isn't called to the rescue or bailout. That's what I'm concerned about.

Mr. Preston, I know you want to say something here because you commented on that.

Mr. PRESTON. Well, you made an assertion that it's a risky business, Senator. I think I indicated in my testimony that it isn't.

Senator D'AMATO. You mean the securities area, the underwriting, et cetera, is not riskier?

Mr. PRESTON. It is not riskier than the business we are presently in.

POSSIBLE FDIC INVOLVEMENT

Senator D'AMATO. So what you're saying is that the FDIC should undertake that.

Mr. PRESTON. No, I did not say that.

Senator D'AMATO. Well, wouldn't you have an advantage if you did do that? You would have FDIC insurance backing the bank and you're going to set up a separate subsidiary.

Mr. PRESTON. As you know, Senator, there is insurance—SIPIC, for the securities industry. We are suggesting that we would be regulated by function and that we would be regulated by the SEC. We would presumably benefit from the SIPIC program. Merrill Lynch with its bank presumably would benefit from FDIC insurance.

The other point I would like to make is that there is no taxpayers' money in the FDIC. FDIC premiums are collected from banks.

Senator D'AMATO. Where do they get that? That's really the American taxpayers' money and, as a matter of fact, I don't know how many billions we rake down here annually, but the truth of the matter is that the bank would be impacted by a securities subsidiary's failure? Is that true?

Mr. PRESTON. A securities subsidiary's failure?

Senator D'AMATO. If you had a separate subsidiary and there was a failure, would the bank be impacted?

Mr. PRESTON. The securities subsidiary might be impacted by the bank failing. I don't think that's the issue. The issue is that the securities underwriting business is less risky than the business the banks are presently in and making 10-year loans, Senator, in this economy is a lot riskier than taking a 5 or 10-minute risk in an underwriting transaction.

Senator D'AMATO. Mr. Budd.

Mr. BUDD. I think it depends upon what kinds of underwriting and what kinds of businesses the investment banking firms are involved in. The overnight positions in securities trading of the Solomon Bros. and First Bostons, et cetera, are absolutely tremendous and I would submit that that indeed can be very risky with the volatility in the financial markets. So I think it's a matter of defining what those businesses are and determining how they are going to be viewed from an oversight standpoint.

I'm not an expert in this field, but I think that's really the issue that has to be dealt with.

Senator D'AMATO. Mr. Chairman, let me commend you for holding these hearings and getting this distinguished panel. Again, I'd like to just simply reiterate my position that I think there should be full interstate banking. That's the one thing this entire panel, as divergent a group as they may be coming from different perspectives in the financial marketplace, can agree upon. Congress can't agree upon it. Although foreign banks can come in and can cross State lines but American banks, whether they come from New York or California, are restricted. I simply think that that does not make sense. It's not right.

Second, I do believe that we should seek stability in the financial marketplace today. Stability is the key. I don't think that undertaking riskier activities at this day and age—and I respectfully

have a difference of opinion with my friends from New York, Mr. Preston and Mr. Shipley—but this is not the time or place for the banking community to undertake the securities market activity with ultimately the FDIC and the American taxpayer being the guarantor.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I'd like to ask each of you to provide for the record if you would, since you're all here essentially arguing for more deregulated environment how you think the regulatory structure should work under the kinds of changes that you would like to see take place. In other words, I'd like to know how you think the current regulatory structure should come down on this revised playing field that you're each suggesting.

Further, I would also like to ask if any of you feel that the regulatory agencies themselves need to be restructured in some way. There has been a good bit of debate about that issue as to whether some of the agencies should be combined or their functions changed. If we're going to move in the direction that you're recommending, I think you should also give us a response as to what changes you think are needed in the structure of the regulatory environment. I think that would be important for us to have and I'd ask each of you to provide it for the record.

[Response to written questions of Senators Garn, Armstrong, and Riegle follow:]



The Travelers Companies
One Travelers Place
Hartford, CT 06183-1000

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
STEWART H. BUELL

STEWART H. BUELL

1000 Park Street, Hartford, CT 06183-1000

Senate Banking Committee Questions

Senator Garn:

Question #1

In your opinion, is the continued blurring of the lines between banking, insurance and securities inevitable? Please explain.

Answer:

The "blurring" actually lies between products and services that financial institutions have begun to offer rather than between the different types of financial institutions themselves. The inevitability of blurring of product is caused by an evolution in the financial services marketplace and the rapid introduction of technological advances. These changes are reflected in refinements to existing products and services, the introduction of new, innovative products, and experimentation with new distribution channels and various forms of joint ventures. These responses to consumer interests and needs have taken place within the boundaries of existing law and will continue to do so. Some have described this process as "blurring" the lines between banking and commerce, and continuing changes in the roles of these institutions may support that view. All of this may also require legislation and regulation that clarifies their roles.

Senator Garn:

Question #2

Should Congress authorize joint ventures among and between the participants in the banking, insurance and securities industry? If so, what types of joint ventures should be permitted?

Answer:

It is questionable whether there is any need for Congress to authorize "joint ventures" among competing financial intermediaries. There are countless numbers of these "joint ventures" taking place today fully consistent with the existing banking, insurance, securities and real estate regulatory systems.

Senator Garn:

Question #3

If Congress does not change the law to recognize the revolution in the financial services industry, what are the risks to the stability of the financial system? How will those risks manifest themselves?

Answer:

The risk to stability in insurance, securities and banking would seem to lie in the management of these institutions; in such areas as leverage, quality of assets to meet financial obligations, and control of fraud and mismanagement. Law and regulation, in any event, do not assure stability. In fact, law and regulation could well cause instability by either preventing justified changes or by forcing precipitous change upon the financial world. The path to stability is determined primarily by management of these financial institutions. Thus, the critical issue for Congress is what effect changes such as expansion of bank powers or closing loopholes will have on how management will react in a fast, changing, market-driven financial services arena.

Senator Garn:

Question #4

The commercial loan market has been "securitized" through the development of the commercial paper market. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Many analysts predict that more and more loan markets will be "securitized" in the future.

Do you agree with the forecast of increasing "securitization" of loan markets and what will this imply for the structure of financial institutions?

Answer:

It is most likely that the "securitization" of the loan markets will continue and increase both in terms of volume and types of loan markets affected. We anticipate that asset marketability will continue to be a high priority portfolio characteristic for financial institutions conducting business in a very competitive environment. We don't view this as structural change for financial institutions.

Senator Garn:

Question #5

Do we face an increasing problem of potential laxness in loan underwriting -- since the institutions which perform the underwriting do not hold the loans and thus are not directly at risk?

Answer:

Increasingly the capital raised in the capital markets consists of securities underwritten by underwriters who do not retain an investment in the issue. Presumably the institutions buying these loans will have underwriting standards that must be met before the loans are purchased.

Senator Garn:

Question #6

At the May 15th hearing you indicated that your opposition to bank holding companies entering the insurance business pursuant to authority granted by the states to state-chartered bank subsidiaries is not a question of states' rights but of competitive threat at a time when insurers are not extended powers in the other direction.

- a. How do you reconcile your opposition, on competitive grounds, to state-chartered banks exercising insurance authority granted by their home state with the fact that several of the largest life insurance companies including Prudential, Aetna, Travelers, John Hancock, New England Life, and Mutual Benefit Life have already acquired or submitted applications to acquire consumer banks or non-bank banks?
- b. If life insurance companies were granted reciprocal banking powers would you continue to oppose, on competitive grounds, the granting of insurance authority to banks or bank holding companies?

Answer:

- a. One of the primary purposes behind the enactment of the Bank Holding Company Act was the separation of banking and commerce. Both the South Dakota and the non-bank bank loopholes circumvent various provisions of the Act and, in so doing, circumvent the underlying intent of Congress. However, to the extent these loopholes are perceived to be viable alternatives in today's financial services marketplace, and to the extent Congress or regulators are unwilling or unable to close them, it is hardly surprising that major competitors in the banking, insurance, and securities industries opt to take advantage of them.
- b. As new financial products continue to evolve, there is much to be said for the "level playing field." Increased competition, to the extent it emerges, can be of value to the consumer. But would this expansion of powers compound the risks assumed by the various financial institutions? That question has yet to be answered. If these risks are not understood and well managed, consumers can suffer from financial failures, as we have clearly seen.

Senator Garn:

Question #7

In your testimony on May 15th you stated that it would have been irresponsible for you not to activate your bank charter in view of the thrust and strategic announcements that many of your competitors have made. Is it your view that banks are the only entities which should be prohibited from responding to their competitors by expanding their services?

Answer:

See answer to 6.

Senator Garn:

Question #8

Would you support a regulatory system based on functional regulation of separate subsidiaries engaged in different segments of the financial industry?

Answer:

Implementation of such a system would be complex and require careful analysis. Without more detail its difficult to express support or rejection. It would be a grave mistake to presume that establishment of subsidiaries would solve the problem of compounding of risks or that establishment of subsidiaries would in fact maintain the stability of financial institutions or protect the publics they serve.

Senator Garn:

Question #9

Given your stated concern for the federal government's ability to implement their responsibilities to regulate and oversee the national financial markets, would you support, as Mr. McElwee does, a system of optional federal insurance charters for those insurance companies which elect to engage in a broad range of financial services including banking, securities and insurance?

Answer:

On the face of the proposal federal insurance charters could lead to more regulation, overlapping regulation, and higher costs to consumers. The proposal's details, when they become available, would have to be

closely studied before any conclusion could be reached on its being in the public interest.

Senator Garn:

Question #10

In his testimony, Mr. McElwee of John Hancock urged us to implement a regulatory system which would allow mutual life insurance companies equal access to the financial services markets. Do you favor a regulatory structure that would provide mutual life insurance companies as well as stockholder owned life insurance companies equal market access?

Answer:

If some broad deregulation proposal ever becomes a reality, we believe it is essential that mutual life insurance companies not be disadvantaged vis-a-vis their stock counterparts.

Senator Garn:

Question #11

It has been reported that Travelers, in moving toward its goal of becoming a full service financial institution, has approved a joint venture between its subsidiary, First Financial Planner Services, and Landmark Bancshares, a Missouri bank holding company. What is the extent of the joint venture? Is the report accurate?

Answer:

No joint venture exists between Landmark Bank and First Financial Planner Services Inc. FFPS is a wholly owned Travelers subsidiary which offers financial planning as a service to the public at retail. The Landmark Bank of Ladue is an FFPS client. They have executed the standard FFPS contracts that all clients execute. Therefore, while there is a relationship between FFPS and Landmark, it is a normal client relationship and not a joint venture.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ARMSTRONG FROM
EDWARD H. BUDD

Senator Armstrong:

Question

At the May 15th hearing you indicated that the financial stresses in both the banking and the insurance industry today lead you to conclude that it would not be timely to support legislation allowing banks or bank holding companies to enter the insurance business, including insurance underwriting and vice-versa.

How do you reconcile that position with you own company's diversification activities which now include, according to your testimony: insurance, mutual funds, securities clearance and execution, mortgage banking, personal trust services, foreign and domestic investment management, pension fund services, cash management services and and FDIC-insured bank?

Answer:

It's essential for every business to position for the future given the changes taking place in the financial services industry. We believe we must explore all the markets and financial services products. While the bulk of our operations continue to be traditional insurance and investment activities, we have taken steps to broaden our base. One only need read the stated objectives of major non-insurance competitors to enter insurance lines to understand the necessity of our developing options for the future.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
EDWARD H. BUDD

Senator Riegle:

Question #1

What concerns, if any, do you have about the strength of the Federal Deposit Insurance System? What would be the effect of increasing the number able to offer deposit insurance?

Answer:

We think the federal deposit insurance system works well. The public as well as the banking system needs such a system. So far as others entering the market for insuring deposits is concerned, this "privatization" of deposit insurance is a possibility -- in fact, the practice exists today to some degree. There is no prohibition against it. To date, however, although some insurance is offered on certain deposits in certain banks, few insurance companies have chosen to make deposit coverage available for an entire bank.

Senator Riegle:

Question #2

Please describe how you believe the regulatory structure would work if broader product and service authorities were authorized to all financial firms.

Answer:

Given the current diversity of regulatory authority as to banking, insurance and securities, with both state and federal regulation, it is difficult to recommend the proper regulatory structure in a more deregulated environment. We continue to support state regulation of insurance. We do not believe that the risks of the insurance, banking and securities businesses are so similar that one "super agency" would be adequate to regulate all aspects of a broader financial services market, particularly as to solvency and reserve issues. Regulation by function, as opposed to regulation by subsidiary structure, has a certain logic to it but this will leave our concern for the aggregation of risks unresolved, and would call for a major overhaul of several regulatory systems. It is difficult now for regulators to keep up with all the changes, technological and otherwise, that occur in the marketplace. Bringing new players into different markets will only compound the regulatory problem.

The Morgan Bank

Lewis T. Preston
Chairman of the Board

Questions for Mr. Preston from Senator Garn

1. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Please explain.

Yes, we think the continued blurring is both inevitable and desirable. There are strong economic and business reasons that are transforming once separate activities into a financial services industry. On the retail side, technological advances, the need to make more efficient use of capital, the phase-out of Regulation Q interest ceilings, increased consumer sophistication and a host of other factors are causing banks and other participants in the financial services industry to offer a broader range of products through their distribution systems. Certain participants--insurance companies and securities firms--have been able to combine insurance and securities activities as well as offer banking products through money market funds and FDIC-insured nonbank banks, while registered bank holding companies are highly restricted in their ability to respond. On the wholesale side, blurring of the lines between previously separate financial market functions has occurred to a substantial extent and will continue, particularly with regard to commercial lending and capital market activities. Borrowers are increasingly relying on the public markets rather than using banks as lending intermediaries. Banking organizations have been able to adapt in their overseas operations by serving their customers as underwriters in the Eurobond market. Domestically, banks have also expanded their capital market activities in such areas as commercial paper and private placements, but the Glass-Steagall Act is preventing banks from fully adapting in their home market to the historic changes that are taking place.

2. Should Congress authorize joint ventures among and between the participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

Congress should authorize participants to engage in all aspects of the financial services industry, without mandating joint venture arrangements as the only form of entry. It may be preferable for some participants to expand *de novo* into other activities--as a number of banking organizations have done in connection with commercial paper services and their Eurobond underwriting activities. For other participants, it may be preferable to make "toehold" or other acquisitions in order to expand into new activities. While joint ventures may work for some participants, the sharing of control involved

in such arrangements can at times complicate the management process and often may not be the most efficient method of expansion. Moreover, a principal advantage of joint ventures--the pooling of one firm's capital with another's expertise--may not be necessary for all participants. Finally, mandating joint ventures would eliminate a key benefit of authorizing increased powers, i.e. the increased competition that results from de novo entry or from improving the competitiveness of an acquired firm.

3. If Congress does not change the law to recognize the revolution in the financial services industry, what are the risks to the stability of the financial system? How will those risks manifest themselves?

If Congress does not revise the legislative framework to recognize the revolution in financial services, the regulated bank holding company segment will become increasingly less competitive than financial service companies not subject to Bank Holding Company Act limitations. This competitive disadvantage for both retail and wholesale financial services will in turn lessen the safety and soundness of individual banking organizations and the system as a whole. For example, as more and more bank lending is supplanted by the public debt market, and more and more banks are unable to continue serving their traditional customers, some institutions in search of satisfactory returns for their shareholders may engage in lending activities that generate substantially higher risks. Moreover, if bank holding companies generally are unable to redeploy their capital to its best use, their profitability and safety and soundness will suffer.

4. The commercial loan market has been "securitized" through the development of the commercial paper market. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Many analysts predict that more and more loan markets will be "securitized" in the future.

Do you agree with the forecast of increasing "securitization" of loan markets and what will this imply for the structure of financial institutions?

Yes, we believe there will be increasing "securitization" of loan markets--including commercial lending. The public markets have already replaced a large portion of bank lending to major corporate borrowers and increased "securitization"

will extend this development to a much larger range of bank lending customers--from middle market companies to consumer automobile loans and other installment credit. The impact of "securitization" will, therefore, be felt throughout the banking industry as the process accelerates. Banking institutions must have the freedom to adjust by providing new products and services in order to remain viable competitors.

5. Do we face an increasing problem of potential laxness in loan underwriting--since the institutions which perform the underwriting do not hold the loans and thus are not directly at risk?

We do not anticipate problems of laxity in loan underwriting because of relevant business and legal considerations. In connection with the sale of "securitized" loans to the public, securities laws and the rating agencies provide substantial protection against such practices. Moreover, because of a concern about potential damage to their business reputation, securities underwriters and dealers will seek to avoid selling poor quality loan pools to investors. In the wholesale market, loans are being sold to sophisticated institutions that are able to make their own credit evaluations, and institutions selling such loans are also concerned with maintaining their reputation.

6. Mr. Budd's statement speaks of "compounding risk" through diversification of financial service firms. Do you agree with Mr. Budd that diversification will increase the riskiness of your firm?

We believe that prudently-managed diversification of financial activities results in reducing rather than "compounding" risk. Commercial lending is a business with declining returns and increasing risks, whereas many financial services--including securities and insurance brokerage--provide a source of diversified revenues from agency and other low-risk activities. Moreover, our experience indicates that further expansion by J. P. Morgan into securities underwriting and trading will permit us to continue serving our customers, who are increasingly raising funds in the capital markets, and to deploy our capital in activities that will reduce our overall risk. Such diversification also permits bank holding companies to obtain the higher returns on equity from underwriting and dealing in corporate securities.

7. What is the value of deposit insurance to J.P. Morgan & Co.? Should we authorize wholesale banks to operate in a much wider range of activities but without any federal deposit insurance?

We do not believe that Morgan's depositors view federal deposit insurance as a major consideration in comparison to capital position, asset quality, liquidity and other measures of financial strength. We agree with the FDIC that participation by bank affiliates in a broader range of securities activities is not risky and does not pose a threat to federal deposit insurance. Bank holding companies, with or without federal deposit insurance for their banking subsidiaries, should be able to offer a broader range of financial services so that they can remain viable competitors.

8. In your testimony, you indicated that securities underwriting is less risky than commercial lending. Would you elaborate and provide data to support your statement?

Commercial lending frequently involves credit exposure for a number of years whereas securities underwriters and dealers are exposed to market risks for a very short period of time--generally a few hours or a few days. Our research indicates that since World War II no securities firm of significant size has failed or suffered serious financial difficulties from underwriting or trading in corporate securities. Instead, the public reports by the Securities Industry Association indicate consistently substantial profits over the years from these activities. Problems in the securities industry have been attributable to back office difficulties, excessive overhead, and fraud and mismanagement. Morgan's research on the risk/return characteristics of underwriting common stock during the period from 1976 through September 30, 1983 (described in pages 15 to 18 of the attached copy of Rethinking Glass-Steagall) also indicates that favorable revenues are consistently generated in this area and that the possibility of large, destabilizing losses is remote.

9. On May 15, you indicated that you believe it would be imprudent for J.P. Morgan & Co. to have 2/3 of its capital invested in real estate. What aggregate and individual limits as a percent of capital would you recommend for real estate? For securities underwriting? For insurance? How would you manage against potential conflicts of interest?

The amount of capital that a bank can prudently invest in real estate depends upon numerous factors, including the degree of diversification and the type of real estate investment, the riskiness of the bank's other activities, and the bank's overall level of capitalization. It is our view that the permissible amount of real estate investment can best be addressed within the framework of risk-related capital standards. If a bank assumed greater risks, it would need a greater amount of capital, but no explicit percentage limit on real estate investment would be necessary.

Provided a banking subsidiary of a holding company has adequate capital for its activities, we do not believe any limit is necessary on the amount of capital the holding company can invest in its real estate, insurance or other subsidiaries. A limit on the amount of capital invested in a securities affiliate, for example, would only restrict the affiliate's revenue generating activities without any prudential justification. Moreover, such a limit would prevent holding companies that own major securities firms and/or insurance companies from establishing or acquiring banks, which we believe they should be able to do.

In our view, expanding the permissible scope of bank holding company activities would not create potential conflicts of interest that are different from those already being successfully dealt with by banking organizations as well as other financial service firms currently offering a broad range of insurance, securities and banking products. All of these companies have a strong economic incentive to maintain the goodwill of their customers and thus avoid exploiting any potential conflict of interest. In addition, common law, statutory and regulatory requirements effectively control potential conflicts that arise as a result of participation in diverse financial activities. The effectiveness of such economic incentives and legal requirements in controlling conflicts was confirmed by the Treasury Department's 1975 study which found, over a 40-year period, no evidence of any actual abuses when a bank acts as a fiduciary and it or an affiliate underwrites municipal securities.

10. Given your knowledge of financial trends, if you were chairman of a small community bank, what changes in geographic and product flexibility would you recommend? A regional bank? Why?

Smaller community banks and regional banks know their respective markets and have, along with their money center counterparts, expressed one overriding answer: Congress should permit them to offer a broader range of financial products, including various brokerage services, so they can respond to the fundamental market developments that are occurring. We agree.

Questions for Mr. Preston from Senator Riegle

1. What concerns, if any, do you have about the strength of the Federal Deposit Insurance System?

As presently constituted, the Federal Deposit Insurance Fund is more than adequate to accommodate any problems that are likely to arise with FDIC-insured institutions. Despite a sharp jump in the number of bank failures in 1984, the fund increased in size to \$17.2 billion at year end from \$15.4 billion a year earlier. The total income of \$3.0 billion far outstripped expenses and losses of \$1.3 billion in 1984.

2. Please describe how you believe the regulatory structure would work if broader product and service authorities were authorized to all financial firms.

We believe that no changes would be required in the current regulatory structure if broader product and service authorities were authorized to all financial firms. Such firms should be regulated by function with a bank (or banks) subject to applicable banking authorities, a securities affiliate subject to the securities laws (including regulation by the Securities and Exchange Commission, insurance coverage provided by SIPC and membership in NASD), and an insurance affiliate subject to applicable insurance regulation.

Although regulatory changes are not required to accommodate broader product and service authorities, a separate question has been raised whether the federal banking agencies should be reorganized. We believe, however, that the critical issue facing Congress is the future structure of the financial services industry. When Congress has addressed this issue, it may become appropriate to consider reorganization of the federal banking agencies.

**The
Morgan
Bank**

Lawrence R. Uhlick
Vice President and Assistant Resident Counsel

RESPONSE OF LEWIS T. PRESTON, CHAIRMAN OF J.P. MORGAN & CO., INC.,
TO QUESTIONS POSED BY SENATOR RIEGLE AT A HEARING OF THE SENATE
BANKING COMMITTEE ON MAY 15, 1985

Senator Riegle asked each of the witnesses to respond to the following questions:

I'd like to ask each of you to provide for the record if you would, because you're all here essentially arguing for a more deregulated environment -- I'd like you to provide for the record how you think the regulatory structure should work under the kinds of changes that you would like to see take place. In other words, I'd like to know how you think the current regulatory structure then should come down on this revised playing field that you're each suggesting.

Further, I would like to ask as a second part of that if any of you feel that the regulatory agencies need themselves to be restructured in some way. There has been a good bit of debate about that issue as you know as to whether some of the agencies should be combined or their functions changed. If we're going to move in the direction that you're recommending, I think you should also give us a response as to what you think perhaps is needed in terms of changes in the structure of the regulatory environment that might make it different from what it is today. I think that would be important for us to have and I'd ask each of you to provide that for the record.

Mr. Preston's response:

We believe that no changes would be required in the current regulatory structure if bank holding company subsidiaries were authorized to underwrite and deal in corporate securities. Such subsidiaries would be subject to supervision by the Federal Reserve Board under the Bank Holding Company Act and would also be subject to Federal securities laws, including regulation by the Securities and Exchange Commission, insurance coverage provided by SIPIC and membership in the NASD. Although this would create some overlap in jurisdiction, it should not create any serious administrative problems and can be justified by the need to insure that the policies underlying both the Federal banking and securities laws are fully observed.

Although regulatory changes are not required to accommodate Glass-Steagall revision, a separate question has been raised whether the Federal banking agencies should be reorganized. We believe, however, that the critical issue facing Congress is the future structure of the financial services industry. When Congress has addressed this issue, it may become appropriate to consider reorganization of the Federal banking agencies.

Response of Finn M W Caspersen
Chairman of the Board of Directors
of Beneficial Corporation
to questions submitted by
Senator Jake Garn and
Senator Donald W Riegle
by letter from Senator Garn
dated June 11, 1985

Questions for Mr. Caspersen from Senator Garn

1. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Please explain.

A. Yes, I believe that the lines between banking, insurance, and securities will continue to blend and blur, as the demand for services, and the technological methods of providing those services, continue to evolve. The only circumstance where such evolution would not continue would seem to be the imposition of arbitrary rules so tight as to preclude innovation and competition. This would not be good policy, in my opinion, and I do not believe the Congress should take such a narrow view of developments in financial services.

2. Should Congress authorize joint ventures among and between the participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

A. Joint ventures are a legitimate form of doing business, and we see no reason that they should not occur among these industries. Although we have no specific ventures to suggest at the moment, there is considerable room for joint use of devices such as Automated Teller Machines (ATM's) and point of sale terminals for marketing of products of each of these industries. The law should not prevent those who find the proper marketing strategy from using a joint venture to make those services available to the public. It is likely such joint ventures will have substantial cost efficiencies that will directly benefit consumers.

3. If Congress does not change the law to recognize the revolution in the financial services industry, what are the risks to the stability of the financial system? How will those risks manifest themselves?

A. The current interplay among the industries has not brought about major risks to the stability of the financial system at this point, and we do not anticipate such problems.

While there currently are parts of the financial system that are somewhat unstable, this does not appear to be a result of the mixing of financial services, nor of competition between or among those industries.

When we look at the problem areas in banking or insurance, they generally involve instances of serious mismanagement or they reflect economic conditions in other industries, or other parts of the economy. For example, some major bank problems have stemmed, at least in large part, from the decline in energy demand and the collapse of energy prices some years ago, and there is risk to the system in certain foreign loans. Much of the savings and loan problem stems from the rapid rise in interest rates over the past ten years or so, and the inability of those institutions to increase their own income due in part to legal and regulatory restrictions and because of the nature of their assets.

Enhanced ability to offer more diverse products and to compete more effectively should lead to greater stability rather than the reverse, particularly in the consumer services area.

4. The commercial loan market has been "securitized" through the development of the commercial paper market. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Many analysts predict that more and more loan markets will be "securitized" in the future.

Do you agree with the forecast of increasing "securitization" of loan markets and what will this imply for the structure of financial institutions?

A. The "securitization" of loan markets is a useful device for bringing investors into the market and for maintaining liquidity. As applied to consumer loan markets it is a relatively new development, and should increase the funding available, and increase the financial institutions ability to market their services and products. I cannot predict what effect this will ultimately have on consumer financial institutions, but it does provide another choice for financing and the marketplace will ultimately determine its value.

5. Do we face an increasing problem of potential laxness in loan underwriting - since the institutions which perform the underwriting do not hold the loans and thus are not directly at risk?

A. The secondary market demands completeness and uniformity of documentation and financial institutions will have to conform to participate. There is no reason to anticipate laxness in underwriting as a general problem. If there is additional risk in loan backed securities, this would be reflected in the pricing of such securities, but does not seem to pose any fundamental risks to the system.

6. Mr. Budd's statement speaks of "compounding risks" through diversification of financial service firms. Do you agree with Mr. Budd that diversification will increase the riskiness of your firm?

A. I do not agree that diversification of financial services increases the riskiness of a firm where the diversification has a well thought out purpose. Quite the contrary, diversification into related areas can strengthen the company as markets change and evolve.

For example, we diversified some nine years ago into the credit card market, and have developed that business into one of the strongest and most important parts of our company.

While diversification simply for diversification's sake can increase risk, well thought out diversification should generally have a positive result, and, in many instances, may be absolutely necessary for survival.

7. Your statement emphasizes particularly the safety and soundness of retail banking. I am concerned to some extent about the loss of lower cost funds in consumer deposits now available for small business. If a consumer bank were authorized would small business' cost of credit increase?

A. I don't believe that authorization of consumer banks would increase the cost of credit to small businesses. While there would be increased competition for deposits, which would permit consumers to earn a better rate, we do not believe this would affect interest rates in general, nor diminish the funds in the system available for small businesses.

8. What role does Beneficial currently play in serving the financial needs of small businesses?

A. Beneficial currently serves small businesses both by making direct loans to small businesses, and by financing the consumer receivables of small businesses.

Direct financing by Beneficial Commercial Corporation occurs through a relatively small amount of leveraged leasing and commercial lending. Other direct lending occurs where state law permits when proceeds of second mortgage loans are used in small businesses owned by the borrower.

On a much larger scale, our Bencharge Credit Service provides substantial amounts of consumer receivable financing for small businesses through purchase of instalment sales contracts and financing of open end retail charge accounts. This valuable service is vital to many small businesses, providing them with credit products and services they need to compete effectively.

Questions for Mr. Caspersen from Senator Riegle:

1. What concerns, if any, do you have about the strength of the Federal Deposit Insurance System? What would be the effect of increasing the number able to offer deposit insurance?

A. There does seem to be a question as to whether the Federal Deposit Insurance System is adequate. This seems to revolve around the question of whether its purpose is to protect depositors' funds to the statutory limit, or to protect institutions which develop problems. A reform that has been suggested, which I believe has merit, involves basing the cost of the insurance on the riskiness of the bank being insured. This would bring some additional discipline to the management of banks, and should reduce the risk to FDIC.

I do not believe increasing the number of institutions able to offer FDIC insurance will increase the risk to FDIC. In fact, it should do the opposite, as it would diversify and spread the risk.

2. Please describe how you believe the regulatory structure would work if broader product and service authorities were authorized to all financial firms.

A. The broadening of authority for all types of institutions should not have a major effect on the regulatory system if products and services are offered through separate subsidiaries or affiliates. Those activities would remain under regulation in essentially the same fashion as they are today.

At the outset, this is the most sensible way for the expansion of authority to evolve, so the various public policies served by the regulatory agencies continue to be served.

As barriers between and among institutions, products and services blur, the jurisdiction of the agencies controlling each activity or institution may have to be changed, expanded, merged, or even eliminated.

Predicting how and when these changes would occur is clearly not possible, but I believe the system will be able to adapt to the changes that will come.

Response by Beneficial Corporation
to Questions Presented by Senator Riegle

Senator Riegle asked for a statement of our position on changes needed in the regulatory structure to accommodate changes we propose in the banking environment. The Senator also inquired whether we had any suggestions for restructuring of the regulatory agencies.

On the first point, we are not advocating any major changes in the regulatory environment of today. We feel non-bank banks, which are subject to the regulatory control of the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, when they have insured deposits, are adequately regulated.

We believe the law already contains adequate protections against tying arrangements to protect consumers, and against improper transactions among affiliated companies to prevent safety and soundness problems.

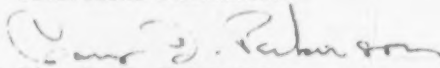
Essentially, we feel the record shows the development of limited purpose banking institutions over many years has not caused any major problems which need to be solved either by prohibiting such entities from existing, or by major changes in the regulatory structure.

We do not see the need for any major changes as this time, although we do support the concept of limited purpose banks, and will support legislation which clarifies their status. If such a new consumer bank, or family bank concept is adopted, as proposed by a number of companies and trade groups, including the American Financial Services Association of which we are a member, it would probably be desirable to segment the control of such institutions within the existing regulatory agencies. We believe such consumer banks would be inherently more stable entities, and there should be no major problems with their supervision, in any event. If legislation of this type should move forward, it would be appropriate to seek suggestions for changes in regulation from the regulatory agencies themselves.

The second question posed by Senator Riegle was whether we felt a restructuring of the current regulatory agencies was needed to accommodate changes that are occurring.

A significant issue some have raised involves the need for or the wisdom of merging the FDIC and the FSLIC. We do not have a position on that at this time, but I would comment on the subject of insurance generally. If the basic purpose of deposit insurance is to provide stability to the banking system, there should be some discipline imposed by the system on both the depositors and the insured institutions. The concept of charging the institutions for insurance on the basis of risk should be explored, and the wisdom of supporting institutions to save deposits beyond announced statutory limits should also be reviewed.

Sincerely,
BENEFICIAL CORPORATION


(For) Finn M. W. Caspersen
Chairman of the Board and
Chief Executive Officer

Responses to Additional Questions
by the Committee on Banking, Housing, and Urban Affairs
of the United States Senate*

Walter V. Shipley
Chairman, Chemical Bank

Questions from Senator Garn

1. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Please explain.

- (A) Continued blurring of the lines between banking, insurance, and securities seems inevitable to me. On the consumer side, the pressures arise from the possibilities for better or more convenient products, such as the availability of discount brokerage or mutual funds through commercial bank accounts. Innovative managers of banks and nonbank financial institutions will attempt to take advantage of individual strengths by developing new products and services that increasingly cross old product lines. Deferred annuities sold by insurance companies, for example, have basic characteristics not dissimilar to term certificates of deposit issued by banks. I do not believe, however, that this process will lead to the total elimination of specialization in narrower product areas. Many institutions are likely to continue to find comfortable and productive niches for their own specialties in the broader framework.

2. Should Congress authorize joint ventures among and between the participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

- (A) I see nothing fundamentally troublesome with the joint venture concept of organization, and thus see no reason for Congress to prohibit these ventures among financial institutions any more than they are prohibited elsewhere. The basic issues are simply what business activities are permissible for the parents and their joint ventures.

In this connection, permitting banks to participate in joint ventures with securities firms and insurance companies should not be the vehicle used to implement reform. Rather, banks themselves should be freed from the restrictions on securities, insurance and other activities. Our financial system will be strengthened when banks have greater opportunities to compete in their own right over broader geographic, functional and pricing areas.

*Relating to testimony before the Committee on May 15, 1985

Even with banking powers broadened to the fullest extent, there will undoubtedly still be instances in which a joint venture form will be advantageous. Such ventures could bring together firms with different strengths to produce a superior product. I believe such combinations should be permitted. Given a sufficiently competitive overall environment, I see no special anti-trust or related problems that could not be handled under existing applicable statutes.

3. If Congress does not change the law to recognize the revolution in the financial services industry, what are the risks to the stability of the financial system? How will those risks manifest themselves?

(A) I covered these points in my testimony. To summarize, I believe that there is no turning back now to some earlier conception of financial structure. Technology and consumer demands will continue to bring change in one form or another to our financial institutions and their products, whether or not it is sanctioned by Congress. Without reform of its basic legal framework, these changes will continue to be loophole and hodge-podge driven. This process does entail significant risks. Most important, in my view, it would permit banks that have survived with relatively weak management and/or a weak competitive structure to continue operating longer than they might otherwise. These banks will become increasingly vulnerable to distress during new periods of economic adversity.

I do not want to imply that legislated reform -- even if done perfectly -- will be completely "painless". Any major change in our financial structure will create at least some stress in some areas. But I believe it would be far better to establish a new and more realistic legislative framework quickly, and to make an orderly transition now, rather than during some future crisis.

4-5. The commercial loan market has been "securitized" through the development of the commercial paper market. The mortgage loan market is being "securitized" through the development of mortgage-backed securities. Many analysts predict that more and more loan markets will be "securitized" in the future.

Do you agree with the forecast of increasing "securitization" of loan markets and what will this imply for the structure of financial institutions?

Do we face an increasing problem of potential laxness in loan underwriting -- since the institutions which perform the underwriting do not hold the loans and thus are not directly at risk?

(A) I believe that the trend toward securitization will continue. It is the result of evolving technology and basic demands by the highest quality borrowers for the lowest priced products that can be developed.

There are both positive and negative aspects to this trend. On the positive side, loan securitization has enabled banks to develop some liquification in portions of their asset portfolios that previously had been considered rather illiquid. On the other hand, the liquified loans tend to be of the highest quality, and the more of these that actually are sold to other investors the more the selling bank is left with a lower quality portfolio.

I do worry about loans that are securitized and sold without any remaining involvement on the part of the underwriting bank. We at Chemical Bank have always believed that to the extent possible any participations that we take should only be from banks that do retain some residual interest in the loans. We follow this same principle in cases where we sell loans to other banks.

One other point might be mentioned. To the extent that securitization is at least partly the result of borrowers' demands for lower priced loans, any reduction in bank operating costs might permit banks to compete more effectively with more traditional lending arrangements. In this connection, so long as banks must continue to "pay" reserve requirements on most of their deposit sources, they will find it increasingly difficult to compete effectively with the commercial paper market in meeting the financing needs of the highest quality borrowers. I would urge Congress to reconsider reserve requirements against nonpersonal time deposits (currently 3%) and enact legislation eliminating them.

6. Mr. Budd's statement speaks of "compounding risk" through diversification of financial service firms. Do you agree with Mr. Budd that diversification will increase the riskiness of your firm?

(A) I strongly disagree with any contention that diversification per se increases the riskiness of a financial institution. To the contrary, many of the basic regulations in banking and insurance are premised on the portfolio management principle that diversification lowers rather than increases overall riskiness.

When Chemical Bank considers diversification into a new product or area, we keep several general principles in mind. One is good management. Any business -- new or existing -- that is poorly managed will obviously involve high risk. My own view is that the more that legislation seeks to continue restrictions on diversification of financial institutions the more likely it is to foster an inbreeding of poor management and an increase in the fragility of the overall financial system.

A second principle is that we manage each product or business in terms of its own inherent riskiness rather than treat them all together at some lowest common denominator. We know, for example, from our already extensive experience in underwriting securities in the Euro-dollar market and the U.S. Government and municipal bond markets, that the risks in these activities are different from the risks in standard bank lending and deposit taking. We also assume that all rules and regulations in force in the underwriting business are just as applicable to us as a bank as they are to nonbank underwriters. We manage accordingly. The legislation that I seek to ease the restrictions on banking activities would in no way change this approach, and thus would not represent any new or increased overall risk to my bank or the financial system.

7. Given your knowledge of the financial trends, if you were chairman of a small community bank, what changes in geographic and product flexibility would you recommend? A regional bank? Why?

(A) I must emphasize that my whole career background has been with a major money center bank. Thus, I am sure that I cannot even hypothetically take on all the traditions and considerations that affect someone who

has grown up in a small community or a regional bank.

But looking at the trends that seem firmly in place and knowing what I know, I start from the premise that the banking industry as a whole faces a fundamental problem of a squeeze on the earnings from the products we sell and an increase in the cost of our raw materials. In trying to cope with this situation in ways that best serve my shareholders -- whether a small community or larger regional bank -- I would want to be able to choose from as broad an array of options as possible.

My interest in broader powers for my own institution would depend on my own circumstances. In some cases, product flexibility might be more important than geographic flexibility. If I were a potential buyer of other institutions, I probably would prefer geographic flexibility on only a regional rather than national basis to limit competition from other potential buyers. But if I begin to think in terms of merging my institution with or selling out to other institutions, I would be keenly interested in seeing the broadest possible geographic flexibility. Clearly, the more potential partners there are, the higher will be the gains for my shareholders. I might note that these considerations played a key role in the Florida National Bank's decision several years ago to look outside its immediate area and seek a merger agreement with Chemical.

8. Why should bank holding companies be given the authority to underwrite and distribute mortgage-backed securities, particularly in light of Bank of America's problem in this area?

(A) The implied premise in this question is that any time one company makes a mistake or ends up having a problem all other companies should be prohibited from that kind of activity. I see no logic in such thinking whatsoever.

To me, the question is why should anyone think of denying banks the authority to underwrite and distribute mortgage-backed securities. Banks and others have been issuing these securities in substantial volumes for more than 15 years, and more than \$300 billion are now outstanding. I think these highly successful efforts are more than ample testimony to the ability of banks to undertake such activities in a responsible and efficient way, with individual consumers, the liquidity of the financial system, and the economy as a whole the clear beneficiaries.

9. In your testimony you indicated that banks can get in trouble if management loses control of risks being taken. How can the federal supervisory process be improved in this area?

(A) I believe that we need to make more efforts to increase the training and competence of bank examiners and to develop closer, more informal, and more on-going communication between bank officers and the regulatory agencies. I have long believed that it would be helpful if bank examiners received some of their training working temporarily as interns in a commercial bank. I also strongly believe that pay scales for examiners and other key personnel in the regulatory agencies must be kept competitive with overall market conditions so that good people not only are attracted to these jobs but more importantly can afford to remain in them. Attracting and keeping chief examiners is especially important. As the level of competence and dialogue is raised, I believe that the

banks themselves would improve their own self-regulation and management, thereby reducing the incidence of trouble spots. The increase in public disclosure in financial statements in recent years has encouraged this kind of self-regulation, and I think the same thing would follow more informal dialogue with the regulators.

The regulators may also need to allocate more resources to on-going self-examination of their policies and procedures. The prods to keep up to date and improve need to come internally as well as externally.

There will, of course, always be some situations that require strong regulatory intervention. I strongly believe that prompt and early action is better than late, and that these situations should not be allowed to fester until they reach crisis proportion.

10. You testified in support of risk-based premiums based on quality. I agree with you. Who should assess quality and how?

(A) I have supported the concept of risk-based premiums for deposit insurance as an idea worth exploring. But frankly, I have not been able to develop a fully satisfactory way to implement it.

I believe that the market place should be the ultimate judge of the quality and riskiness of each individual bank. The ratings resulting from bank examination procedures are of some guide, but not as good as an informed market. I find sharply focused comparisons of Chemical with our peers particularly helpful. Such comparisons are common at meetings with the market rating agencies and security analysts. At most meetings with the bank regulators, I learn about their views of my own bank, but not in the broader context that challenges me to defend why our way of doing things is better than someone else's and that clearly shows where we stand and how we might improve.

I am not sure how any of this information can be processed satisfactorily into a fee schedule for deposit insurance for some on-coming period. But it might be possible to work out some schedule in which all banks pay the same insurance fees up front, but then receive rebates depending on overall performance and ratings over some period of three or four consecutive years.

Questions from Senator Riegle

1. What concerns, if any, do you have about the strength of the Federal Deposit Insurance System?

(A) I believe that the Federal Deposit Insurance System is fundamentally sound, and has worked quite well. We must remember that the financial system and the whole economy have been through some extremely trying circumstances over the past decade, including both severe inflation and severe economic slack. The system has survived, however, at least in part because of the effectiveness of the deposit insurance mechanisms. Some weaknesses have been uncovered, to be sure, and these should be corrected if possible. But I would hate to see any drastic changes that would introduce possible new instabilities into a system that has worked.

2. Please describe how you believe the regulatory structure would work if broader product and service authorities were authorized to all financial firms.

- (A) The regulatory agencies simply will have to adapt. This is really nothing new. The national and international structure of the largest banks already has strained the division of regulatory authority among Federal agencies and, in some cases, individual Federal Reserve banks. And there is a continuing stream of new banking products, demanded by our customers, with which the regulators must become familiar. In cases where we enter new activities outside of present banking, these areas should be subject to the same kinds of regulation and examination required of other companies engaged in such activities. I believe that solutions exist and can and will be found.



JOHN G. McELWEE
CHAIRMAN
AND
CHIEF EXECUTIVE OFFICER

RESPONSES TO QUESTIONS FROM SENATOR GARN
JUNE 28, 1985

1. In your opinion, is the continued blurring of the lines between banking, insurance and securities inevitable? Please explain.

The financial services industry is already one industry of which banking, securities and insurance services are component parts. Technology has provided both purchasers and providers of financial services and products better information regarding alternatives in the marketplace and has fostered a greater degree of sophistication. There is an increasing awareness among providers that consumers want financial intermediary services tailored to their particular needs. The historic origin of the financial services provider is less critical to the consumer than the nature and quality of the product or service being offered. These factors have led and will continue to lead to an expansion of financial products and services. The Merrill Lynch Cash Management account with over 1 million subscribers is a classic example of a financial intermediary service which combines a number of financial services in one product. Insurance products such as Variable Life, Universal Life, and the new hybrid Flexible Premium Adjustable Life offer various combinations of risk protection and investment opportunities. Mutual funds are another hybrid product, offering investment benefits plus transaction capability. Bank holding companies and banks can offer discount brokerage services. Variable annuities, although registered with the SEC, have traditionally been perceived as insurance products. Recently, the Comptroller of the Currency approved the sale of variable annuity contracts by discount brokerage subsidiaries of national banks, based upon the premise that variable annuities are securities rather than insurance products.

As new product designs and marketing techniques are developed to satisfy customer needs, the labels attached to the particular product or provider become less meaningful. The marketplace will continue to identify functional needs and will produce financial intermediary products and services which satisfy those needs. While those new products are designed to comport with existing artificial legal barriers, the functions performed by those products and services have already expanded beyond the historic segmentations which were drawn to respond to times and circumstances which no longer exist.

RESPONSES TO QUESTIONS FROM SENATOR GARN

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2. Should Congress authorize joint ventures among and between the participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

Many contractual arrangements between independent parties already are taking place in the financial services markets. For example Merrill Lynch and Bank One forged an agreement which led to the creation of the Cash Management Account. Banks offer discount brokerage services through arrangements with unrelated brokerage houses. Brokerage firms market pension products of insurance companies. Some insurance companies, including John Hancock, offer credit cards to their policyholders through arrangements with banks. Credit card companies market group insurance products through mailings enclosed with their monthly billings. Banks are leasing space in their lobbies to insurance agents either on a fixed rental or percentage of volume basis. Although these types of contractual arrangements may not always fall within a specific or technical definition of a joint venture, the functional result has already become common in the marketplace through such contractual relationships. Specific authorization of "joint ventures" between financial services providers would constitute a very limited step toward the recognition of the radical changes which have already occurred in the operation of the financial services marketplace and by itself would not be responsive to the clear need for a comprehensive restructuring of the regulatory framework.

3. If Congress does not change the law to recognize the revolution in the financial services industry, what are the risks to the stability of the financial system? How will those risks manifest themselves?

If Congress fails to change the law to recognize the revolution which has taken place in the financial services industry, competitive inequality will continue in the marketplace. Banks suffered serious disintermediation when mutual funds offered much higher interest rates than Regulation Q permitted banks to offer. Similarly, the thrift industry suffered a loss of deposits under Regulation Q's restrictions.

Absent a restructuring of the entire financial regulatory framework, some providers will be restricted by antiquated laws as to the financial products and services they may offer, while other providers escape such restrictions due to their historic origin or form of corporate organization. Disintermediation will occur based

RESPONSES TO QUESTIONS FROM SENATOR GARN

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on competitive inequality among providers resulting in large part from the application of outdated laws to a radically changed marketplace. Those providers which are hampered by artificial restraints on product offerings will suffer further erosion of their market share.

Congress has the opportunity to recognize the revolution in the financial marketplace and devise a fair and equitable regulatory structure which will allow competition to flourish based on quality of products and services. If Congress does not act, competitive imbalance will continue to occur based on the fortuitous application of barriers and restrictions on some participants in the industry, but not others. The plight of the thrift industry in the last decade provides the clearest example of the risks inherent in delaying modernization of the regulatory structure. It would be unfortunate indeed if Congress chose to wait until there were further financial crises before making necessary and equitable adjustments to the regulatory structure of the financial services industry. However, piecemeal adjustments to the regulatory structure of a single segment of the financial services industry will not provide an adequate solution. A regulatory framework for the entire financial services industry which allows reciprocal market access for all providers, including mutual life insurance companies, is needed.

4. The commercial loan market has been "securitized" through the development of the commercial paper market. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Many analysts predict that more and more loan markets will be "securitized" in the future.

Do you agree with the forecast of increasing "securitization" of loan markets and what will this imply for the structure of financial institutions?

We do agree with the forecast of an increasing "securitization" of loan markets. Securitization is a mechanism that allows financial institutions to better react to changes in the financial marketplace. It is a mechanism that has become increasingly more useful and practical as a result of improvements in technology which enable institutions to keep the complex but accurate records necessary in modern money management and investment. With this technology institutions can now better manage changes in the financial marketplace by using securitization to liquidate previously illiquid investments to restructure portfolios.

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5. Do we face an increasing problem of potential laxness in loan underwriting - since the institutions which perform the underwriting do not hold the loans and thus are not directly at risk?

We should not face a growing problem of laxness in loan underwriting as a result of the market in those obligations. If mortgage loans are packaged by the lending institutions and used as collateral, risk remains with the institution originally underwriting the loan, even though the loans have been securitized.

Even in those cases in which the initial lender actually sells loans to other institutions which either keep such obligations or package the loans as collateral the marketplace appears to respond in a predictable fashion to the risk being transferred. For those obligations which are packaged in pass-through securities and are publicly rated, the rating agency reflects the risk in its rating and hence affects the price. Those mortgage-backed obligations which do not apply for a public rating sell at a lower price as a result. Accordingly, as institutions compete in these markets, the quality of their loan portfolio continues to be significant. In addition, those mortgage obligations which are sold are subject to scrutiny by an unrelated third party and the examination may be more careful in certain respects than if those obligations were retained by the institution underwriting the loans. In some cases, this may mean that the better quality, rather than the lesser quality loans are candidates for sale. We are already realizing some standardization in loan documentation in this market which not only facilitates the sale of such obligations but also helps in analyzing the underlying obligations. As the market for these loans matures, we should observe a greater demand for information about credit quality, which will also allow better assessment of the underlying risk involved.

6. Mr. Budd's statement speaks of "compounding risk" through diversification of financial service firms. Do you agree with Mr. Budd that diversification will increase the riskiness of your firm?

We do not agree that diversification necessarily increases the riskiness of our company or of other financial services providers. Diversification allows a company to offer to its present and prospective customers a variety of options which may service the changing financial needs of that customer over his or her life cycle. By offering a full range of financial services, a company avoids the greater risk of having its customers transfer loyalty to a company which can provide a more complete range of products and

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services. Offering a full range of financial products will also give to the customer the option of transferring assets among different products as his or her needs change, thereby allowing a smoother transition for both customer and provider and avoiding the disintermediation which can occur if competitive products are not made available. Diversification actually lessens the risk to individual companies and the industry while providing greater convenience to the customer. If risk exists, it arises not from the mere fact of diversification but from lack of management competence or inequitable application of inappropriate laws that create or aggravate competitive inequality in the marketplace.

7. In reading your testimony, you indicated that the federal requirements for an upstream holding company preclude mutual life insurance companies from full participation in the financial services markets. Could you be specific on what areas of participation are denied to your company presently because of your mutual form of organization? Do these result from inflexibilities in state laws under which you are regulated? Please refer to Sec. 113 of S. 2851 as it passed the Senate during the 98th Congress. What changes would be necessary to the Mutual Savings Bank Provision to recognize the difficulties of the mutual insurance company?

Federal banking deregulation proposals have generally been premised on the formation and utilization of an upstream holding company. Focusing only on the structural organization of most banking institutions and contemplating the expansion of financial services through subsidiaries of an existing upstream holding company, such proposals presume that the holding company will not have any independent operational significance.

As applied to a mutual life insurance company able to diversify only through separate downstream subsidiaries of the mutual parent, such proposals are simply too limited to provide reciprocal market access for all financial service providers. Bank holding companies would be afforded new, broad insurance powers for their insurance company subsidiaries. Non-operating holding companies of competing stock life insurers would be able to respond by conducting a broader array of banking services through newly formed or expanded banking subsidiaries. Meanwhile, mutual life insurers could take advantage of the expanded bank subsidiary authority granted to them only by dismantling their existing operations or entirely revamping their corporate form. Put more specifically, in order to comply with the structural rigidity of the Bank Holding Company Act, the mutual life insurer is left with two

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equally untenable options. It can liquidate its principal business, the parent's vast insurance operations, essentially forfeiting its corporate franchise. Alternatively, without the benefit of any meaningful legal precedent and with no assurance as to either its practical or financial viability, the mutual life insurer may pursue conversion to stock form and the simultaneous formation of an upstream holding company.

In this regard, you have inquired whether Section 113 of S. 2851, the Mutual Holding Company Amendment, might be modified to address this problem. Section 113 purports to address the organizational disadvantages of the mutual form by providing a streamlined procedure for mutual thrift institutions to form an upstream holding company. Under the terms of this Mutual Holding Company Amendment, the mutual depository charters a downstream stock savings institution and, transfers a "substantial part of its assets and liabilities" to this downstream entity, leaving the mutual parent as a non-depository holding company held by the depositors of the former mutual thrift.

Though superficially appealing, the legality of this Amendment, even as applied to thrift institutions, is unclear. While appearing to impose a holding company structure over the thrift institution by merely exchanging the interest held by the mutual depositors for an analogous interest in the holding company, the proposal in fact works a change of ownership. Unlike the mutual depository which would have been operated for the benefit of its depositors in perpetuity, the mutual holding company is to be held by the former mutual depositors only during their lifetime. Having made no provision for the disposition of their aggregate interest, once the former mutual depositors pass away, the holding company will ultimately be held by no one. Whatever the relevant public policy, such a procedure is entirely at odds with the Federal Home Loan Bank's Board's conversion regulations and appears to raise substantial Constitutional concerns.

Aside from the Amendment's legal infirmity, there is some question whether it is even possible to address the disparate rights of mutual depositors and mutual policyholders in one broad proposal. Mutual life insurers unlike thrift institutions, have independent, long-term contractual relationships with their policyholders. These policies raise distinct Constitutional impairment of contract issues unique to a converting mutual life insurer. For example, absent novation by each and every policyholder, the mere transfer of an insurer's contractual

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liabilities to a downstream subsidiary, as contemplated by the Mutual Holding Company Amendment, would work a breach of contract.

Whatever the problems associated with this Amendment, existing state conversion laws provide no greater consolation for mutual life insurers. Most states with a dominant mutual life insurance industry presence either prohibit or fail to provide for conversion. In the remaining states, the myriad of conflicting statutes raise entirely unprecedented legal issues and generally impose unrealistic obstacles which undermine the financial viability of the converting insurer.

Accordingly, especially for mature mutual life insurers, the imposition of a regulatory structure premised on the formation of a non-operating, upstream holding company becomes a practical barrier to the mutual life insurance industry's full participation in a diversified financial services market. If bank holding companies were granted broad insurance underwriting and agency powers, reciprocal market access would be entirely illusory so long as mutual life insurance companies were required to convert and form a holding company to offer commercial banking services.

Recognizing the inequity which would have resulted if state insurance law only allowed diversification through subsidiaries of an upstream holding company, state regulation has uniformly provided mutual life insurers a downstream diversification capacity through wholly-owned subsidiaries. These subsidiaries are operated as separate economic entities subject to stringent subsidiary investment restraints and pervasive regulatory oversight. Equally able to accommodate affiliate transaction, tie-in and similar regulations common to the upstream regulation, downstream diversification authority has proved an effective and appropriate method of regulating mutual life insurers. There is no legitimate reason why a federal deregulation proposal cannot similarly accommodate the mutual life insurance industry.

8. On May 15, you urged the Committee to act as soon as possible and as broadly as possible. Specifically what are the risks to the financial system as a whole if Congress does not take your advice? To large and/or small insurance companies? To large and/or small banks? To the public?

The risk to the financial system as a whole if Congress does not take action to devise and implement a fair and equitable regulatory structure for the financial services industry is the

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continuation of competitive inequality in the marketplace which will arbitrarily favor or disadvantage financial providers based on inappropriate legal barriers inherited from times and circumstances which no longer exist. Artificially imposed barriers to full and fair competition can only lead to disintermediation and weakening of those financial providers which are disadvantaged by an antiquated legal structure.

Both insurance companies and banks will sustain major loss of market share (with the consequent loss of funds for capital investments) if prompt, broad regulatory restructuring does not occur. These regulated industries need to be in as good a competitive position as the emerging diversified financial services complexes whose ultimate parent is not in one of the regulated industries. This is particularly true of large insurance companies doing business nationwide which are too large and diversified to be boutiques. Smaller companies can carve out market place niches either on a geographical or product line basis as the larger companies cannot do.

As the competitive viability of the larger companies deteriorates, the public will lose both as consumers of financial services and as the beneficiaries of the investment of capital which these larger institutions make available to industry, agriculture, housing, commercial real estate, venture capital, etc.

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1. What concerns, if any, do you have about the strength of the Federal Deposit Insurance System? What would be the effect of increasing the number able to offer deposit insurance?

The Federal Deposit Insurance System has obviously been burdened by the failure of institutions. As strict regulatory restraints on business practices have been removed, management has become a far more critical factor in the successful operation of a banking business. Increasing the number of institutions able to offer insured deposits would not necessarily weaken the Federal Deposit Insurance system. It is not the number of institutions per se but the quality of management of such institutions which has an effect on the insurance system. Although risk-based premiums is an appealing concept, it is difficult to determine a unified approach to assessing the riskiness of a particular business. Diversification of activities is not inherently risky nor is the mere existence of a particular business activity or combination of financial services activities. The critical task for the system will be the assessment of many combined factors including the activities engaged in by institutions, the resources available to them, and the ability of their managements.

2. Please describe how you believe the regulatory structure would work if broader product and service authorities were authorized to all financial firms.

As I described in my testimony, we believe that a system of functional regulation can best accommodate the financial services industry. Under such a system of regulation, different financial products and services would be offered through separate but affiliated companies. Each sector of the financial services market - banking, life insurance, securities and others - would be regulated separately. Each separate subsidiary or affiliated company would be subject to the appropriate regulatory body having jurisdiction over the function being performed by that particular company, whether it be a bank, an insurer or a securities firm. Financial services organizations should be free to enter any or all segments of the financial services industry subject to regulation in each segment in which they participate.

Preventing common ownership of companies that offer the various components of the financial services market is an anticompetitive and ineffective means of regulating the financial services industry.

We believe that consumers should be free to purchase financial services from the broadest range of competing organizations. To institute a regulatory structure which provides anything less than full reciprocity will concentrate the provision of financial services in selected segments and foreclose competition by other providers. It is imperative that any federal proposal to restructure the regulatory environment be premised on reciprocal market access so that all financial services providers may participate equally in the marketplace.

Reciprocal market access cannot be achieved unless provision is made for the unique nature of mutual life insurance companies. A mutual company is held by its policyholders and has no stock. It is impossible for a mutual life insurer to form an upstream holding

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company. A federal regulatory framework which requires, as a structural prerequisite, the formation of an upstream holding company would effectively preclude mutual life insurance companies (which hold 56% of life insurance industry assets) from full participation in the financial services markets. We see no reason why financial services diversification must be based solely on the concept of an upstream holding company.

The Canadian Department of Finance has recently released a study of the Canadian financial markets and a proposal for regulation of Canadian financial institutions which would permit diversification through a financial holding company structure. Included within the Canadian proposal is a recognition of the need to accommodate the mutual insurance company form of organization by authorizing downstream diversification for those entities. That study states:

"Since mutual insurance companies are owned by their policy-holders, they cannot, without modifications to their corporate structure, be owned by a financial holding company. While the federal government will give consideration to the terms and conditions under which mutual companies that so wish could convert to stock companies, it will also ensure that mutual companies have access to the holding company approach in their present corporate structure.

First, mutual insurance companies would be permitted to create a downstream group of affiliates by investing surplus funds in such new companies. This would have to be done within limits to ensure that policy-holders' interests are appropriately handled.

Second, consideration will be given to permitting mutual insurance companies to raise funds for expansion of such downstream affiliates through the issue of subordinated debentures.

These various measures would provide mutual insurance companies considerable scope to participate in the holding company approach and to offer a wide range of financial services to their customers'.

(The Regulation of Canadian Financial Institutions:
Proposals for Discussion, Department of Finance, Canada, April 1985,
page 41.)

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Regulation by function under which separate subsidiary or affiliate companies offer the different components of the financial services industry, subject to the regulatory body which oversees the function being performed, would allow all financial providers regardless of their form or organization, to participate and compete in the marketplace.

Presently, state and federal regulatory barriers prevent mutual life insurers from full participation. Insurers are subject to the jurisdiction of each state in which they do business and the regulatory pattern among the states is far from uniform.

Unnecessary regulatory conflicts could be avoided by providing insurance companies which chose to diversify the option of a federal insurance charter. Those insurance companies which, because of their size, market niche or other considerations, elected to remain specialized insurance providers should be free to do so and need not change.

If Congress chooses not to authorize a preemptive system of federal insurance charters, it should at a minimum acknowledge that there are and will continue to be conflicting state laws which restrict insurance company diversification. Unless Congress addresses this problem, it will not have given the life insurance industry equal market access.

We recognize that there are many practical and political realities which will have a bearing on any effort to restructure the existing regulatory environment. Rather than offer an inflexible blueprint for a regulatory structure, we have addressed the question of regulatory philosophy for what is now a single financial services industry. We believe that the guiding principles in constructing a new system of regulation must include reciprocal market access for all providers, regulation by function, federal preemption of conflicting state insurance laws and accommodation of the mutual form of organization. We hope that you will give us the opportunity to work with you in constructing a regulatory structure which will be fair and equitable to all providers.

QUESTIONS FOR MR. TELLING FROM SENATOR GARN

1. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Please explain.

A. Yes. Firms engaged in banking, insurance and securities activities are all financial intermediaries, competing with one another for the disposable resources of business and individual savers, and for the opportunity to direct these funds into productive investments in the economy.

This has always been true, but a number of factors combined in recent years to encourage firms in each of these fields to offer many increasingly similar products, and this has made their competition increasingly apparent to consumers of those products. These factors include the well known advances in computer and communications technology, legal and regulatory changes, and changes in the general economy. The most dramatic example of the last factor was of course the run up in inflation and interest rates which, coupled with the low rate ceilings mandated by Regulation Q on deposit accounts, led to consumer demand for alternative products offering a market rate of return. There are many examples of this blurring phenomenon, for both the funds-gathering and funds-investing sides of the intermediary business.

Looking first at competition for the saver's dollar, banks have traditionally offered savings accounts on which a fixed rate of return is paid, and the saver is assured of return of principal at par virtually on demand. With the advent of computers, and as a result of general interest rates rising above the Regulation Q

ceilings, it became possible for securities firms to respond to consumer demand for better returns through a similar product--the money market mutual fund--in which the saver could be virtually assured of a return of his principal at par on demand and a market rate of return on his investment. The mutual fund was also incorporated into the central assets account (such as the Merrill Lynch Cash Management Account) which featured a limited transaction account capability.

Securities firms offered professional investment management to customers through combining their small individual accounts in large pools called mutual funds; insurance companies countered with separate accounts for variable life and annuity contracts that combined professional investment management with a more traditional insurance product; and banks countered with common trust funds.

Banks once offered corporate and government cash managers the only safe repository for overnight or short term excess cash. Banks had custody of the customer's cash resources and a unique knowledge of the creditworthiness of overnight or short-term borrowers. Securities firms, along with other institutions, countered with the development of a repo market in U.S. Government securities, bringing together short-term borrowers and risk-averse lenders.

Turning to the lending/investment side of the process, insurance companies compete directly with banks in providing commercial and mortgage financing as portfolio investments; banks compete with insurance companies in offering standby letters of credit which can be designed as virtual substitutes for fidelity or guaranty contracts.

Securities firms have competed directly with banks for the provision of short and medium term business credit, through commercial paper underwriting and other techniques. (Banks are themselves moving into the commercial paper market.) Again, this has become possible because of technology -- in this case the development of communications systems that permit instantaneous world-wide contact with potential investors and the immediate dissemination of up-to-date financial information about particular investments.

For the foregoing reasons, it is not surprising that the lines between banks, insurance companies and securities firms are blurring, and will continue to do so, through their offerings of many similar products. These lines developed initially because of the state of technology and the degree of sophistication of savers and borrowers at the time. As we have seen, the lines are not immutable or the product of complete and inherent differences between these businesses. The unfortunate fact is that our laws and regulations do not change as rapidly as our financial institutions need to change in response to market conditions.

This inevitable blurring process is one of the important factors that lead us to conclude that the Congress needs to re-examine the basic structure of financial services regulation. It is essential that the regulatory structure mirror the realities of the financial services marketplace and be flexible enough to respond to inevitable changes in that marketplace. The traditional approach results, as we have seen, in a fruitless and endless process of chasing loopholes.

This is not the place, nor would we presume, to attempt to describe in detail what should be the structure of a more rational

scheme of regulation. In general, however, what is called for is to start with a fundamental re-examination of the primary purpose of regulation -- what is it that we are seeking to achieve? Once that is made clear, then a system should be designed that best achieves that purpose, while taking into account the marketplace realities referred to above. For example, if safety and soundness is a core regulatory objective, then perhaps a focus on capital adequacy coupled with improved examinations for quality of assets and competence of management is the right approach toward effective regulation to address that issue.

In the design of the regulatory scheme, we support the concept of conducting each of the basic financial services businesses (insurance, securities, banking) in separate holding company subsidiaries that are subject to the same regulations that apply to competitors in the same business. This preserves the regulatory restraints related to safety and soundness (such as capital adequacy) and integrity of the marketplace (anti-tying and anti-discrimination laws, for example) applicable to each basic line of business, including constraints on transactions with affiliates. At the same time, it allows these companies, through affiliates, to respond to shifts in consumer demand and other changes in the marketplace.

2. Should Congress authorize joint ventures among and between the participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

A. From what was said in answer to the first question, it should be clear that firms in the banking, insurance and securities industry should be allowed to join together, through direct

affiliation or otherwise. Joint ventures are one form of such combination and should certainly be permitted. As noted, firms in these fields already offer many similar products and services, and the authority to combine them will minimize the waste of public and private resources involved in the attempt to keep them totally separate.

Having said this, it is worth pointing out that no action by Congress is required to permit joint ventures or other affiliations between securities and insurance firms. Present Federal laws do not impede such combinations and many have already been formed.

Many banks and other depositories have also formed contractual or joint venture arrangements with other financial service providers, such as insurance companies that have facilities in bank premises. The Comptroller of the Currency has allowed such arrangements for national banks, and several state insurance departments have addressed this issue.

The question whether banks controlled by bank holding companies can engage in joint venture arrangements is unclear, depending on the structure of the particular arrangement. This is, accordingly, an area that merits your Committee's attention.

The appropriate Congressional response, however, is to go beyond joint venture authority. As indicated above, we advocate a lifting of the restrictions of the Bank Holding Company Act and the Savings & Loan Holding Company Act to permit diversified companies to control depositories and other financial service providers, as well as other businesses. The holding company structure will allow efficient competition in the provision of all financial services,

and each affiliate will be subject to regulations common to all competitors in the same core business.

3. If Congress does not change the law to recognize the revolution in the financial services industry, what are the risks to the stability of the financial system? How will those risks manifest themselves?

A. If there are no changes in the laws -- primarily the banking laws -- now applicable to the financial services industry, the risks to the financial system over the long-term appear to be serious.

In speaking of risks, I am putting aside the very important matter of the benefits that the economy and consumers would derive from an explicit recognition in our laws that we now have, to a large degree, a financial services industry in this country and not three totally different kinds of financial intermediaries. Such a recognition, permitting combinations among these intermediaries, would produce more efficient competition, more innovation, better capitalization of participants, and -- above all -- better and lower cost services for business and individual consumers.

But the risks themselves are a factor worth addressing, and because it is the industry most restricted by problematical regulation, these risks principally arise in the banking industry. Your Committee was fortunate to receive testimony during its hearings from James McCormick, President of the First Manhattan Consulting Group. I say you were fortunate because Mr. McCormick offered an early warning of what can occur in the banking industry over the next decade.

Mr. McCormick said that changes in the economy -- driven by changes in technology -- are rapidly eroding the traditional role of banks as intermediaries. To survive, banks must change their ways of doing business. Congress should facilitate this transition, not impede it, and this "will require elimination of constraints that preclude banks from evolving into more efficient intermediaries." Mr. McCormick continued:

"Failure to provide relief will relegate banks to an outmoded method of competition and will likely lead some banks to take greater risks causing further bankruptcies, threats to public confidence, and drains on FDIC reserves."

We are beginning to see some evidence of the accuracy of Mr. McCormick's forecast. The June 21, 1985 issue of the American Banker contains a series of articles summarizing a survey of lending by the 100 largest U.S. banks during 1984. While it is difficult to separate out the consequences of year-to-year changes in the economy, this survey indicates a decline in the level of commercial lending by the largest banks, and that the most significant area of growth in their activity is in the so-called "invisible bank"--services that do not involve direct lending, such as standby letters of credit and loan commitments, which are off the balance sheet. While part of this may be due to other factors, it has probably resulted to a significant degree from the fact that alternative commercial financing arrangements, particularly for the larger corporate borrowers, are becoming more attractive.

Of course, none of this yet amounts to a crisis, but that is just the point. These are indications that Mr. McCormick's forecast may be accurate and should not be ignored when there is

time to act. Banks are under tremendous economic pressure to expand and diversify into new areas of intermediary activity -- insurance and securities are examples -- and are already doing so where the law permits. But if their traditional base in commercial lending continues to erode and cannot be supplemented with other services demanded by their customers, the financial system may confront a crisis for commercial banks not dissimilar to the crisis now faced by the savings and loan industry. In both cases, overly strict regulation -- confining the industry to a single line of business while the economy changes around it -- will tend to force an industry to take risks for survival that are not prudent. Ironically, to refuse to change the laws -- in the service of an objective such as safety and soundness -- may bring about exactly the opposite result from that intended by those who saw these constraints as promoting a healthy financial system.

4. The commercial loan market has been "securitized" through the development of the commercial paper market. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Many analysts predict that more and more loan markets will be "securitized" in the future.

Do you agree with the forecast of increasing "securitization" of loan markets and what will this imply for the structure of financial institutions?

A. We believe that securitization will increase, particularly in the form of packaging pools of loans and other financial assets and selling interests in those pools to the investing public. We are seeing more and more new types of loan pools, for example automobile loans, being offered to the public through this technique.

This phenomenon is a result of several factors that will persist. These include:

- o With deregulation of deposit interest rates and increased competition for loans, depositories are subject to continuing pressure on the lending spread -- the difference between their cost of funds and rates charged on loans. As is often observed, this pressure has driven the depositories to move into fee based rather than spread based lines of business. Securitization of mortgage loans, for example, allows savings and loans to become, in part, mortgage bankers that originate loans, sell them into the securities market, and service the loans for investors. This is partly replacing spread-based portfolio lending as a source of revenue.

- o These arrangements add an important measure of flexibility in asset/liability management for depository institutions, which of course has been made possible only relatively recently through advances in computer and communications technology.

Because securitization improves the efficient allocation of capital in the economy, and gives investors more investment opportunities, it is a desirable development that certainly should not be interfered with by new regulatory restraints.

Securitization also provides opportunities for depositories to continue to play an important role (as loan originators and servicer) in the intermediary process, and makes them more efficient in that role. To interfere in this process with regulatory action would remove those benefits. For that reason, it is important in any new legislation concerning the "thriftiness test" applicable to

savings and loans to give strong recognition to mortgage banking (loan origination and sale) activities as satisfying that test. Further, we believe it is important to allow depositories to affiliate with companies that can sell securities backed by financial assets, so that the holding company can be involved in all aspects of the lending process.

5. Do we face an increasing problem of potential laxness in loan underwriting - since the institutions which perform the underwriting do not hold the loans and thus are not directly at risk?

A. Of course not. As in every other area of commerce, if you are known to sell shoddy goods, you do not survive competition. If a loan originator--a bank, savings & loan, or mortgage banker--produces poorly underwritten or documented loans, investors will soon refuse to do business with that company. Companies involved in this process, such as many of our own companies, depend on their reputation with investors (either portfolio investors or managers of public offerings) for producing a quality product and are extremely concerned about preserving that reputation. What actually occurs is that investors, or their representatives, provide another layer of monitoring of loan products, in addition to that of the loan originator itself.

6. Mr. Budd's statement speaks of "compounding risk" through diversification of financial service firms. Do you agree with Mr. Budd that diversification will increase the riskiness of your firm?

A. As I am sure you know, it is a widely accepted principle of economic analysis and business management that diversification,

generally speaking, is a recommended technique for reducing risks. That principle certainly applies in this instance. It is an application of the old maxim that you shouldn't put all your eggs in one basket.

We have an excellent example at hand of the risks involved in failing (or being legally unable) to diversify, namely the savings & loan industry. That industry's financial difficulties are a direct result of legal impediments to diversification, and it has suffered the consequences in a changing economy. As indicated earlier, if the banking industry is proscribed from diversification, through affiliates, it may also be injured.

Of course, not every step towards diversification is risk reducing in every circumstance. This raises a question implied in Mr. Budd's statement whether, in comparison to the banking business, other lines of business are more or less risky. It appears to us that the banking business is at least as risky as most other businesses, particularly other financial services businesses. So a banking company's expansion, through affiliates, into other businesses does not imply an increase in risk for the entire company.

We emphasize diversification through holding company affiliates because that is the method, as noted in answers to the previous questions, that we are advocating. This structure certainly minimizes the increment in risk, if there is any, to the individual subsidiaries engaged in financial services, since each would be separately capitalized, managed and regulated, and creditors of one would have no claim on the others.

To answer your question more specifically, we certainly do not believe that our diversification increases the riskiness of our company. We decided upon expansion of our involvement in financial services in part to reduce overall risk over the long term.

7. Your statement emphasizes particularly the safety and soundness of retail banking. I am concerned to some extent about the loss of lower cost funds in consumer deposits now available for small business. If a consumer bank were authorized would small business' cost of credit increase?

A. No. Since the Garn-St Germain Act of 1982, and the elimination of Regulation Q that ensued, all depository institutions have been competing for the public's funds through the interest rates they offer on deposits. Brokered deposits have made this competition even more efficient.

If we assume, as we should, that there is a limited amount of money that can be obtained at any given time in this manner by all depository institutions, it will be divided through lending between consumers and businesses according to where the profit is greatest, consistent with risk. If consumers begin to pay relatively higher rates on their loans, consumer loan rates will eventually fall -- because of supply and demand -- to such a level that it is no longer relatively more profitable to make consumer loans. Business loans will take up the rest of the lendable funds, again only so long as the spread between the cost of money and what borrowers will pay makes lending profitable.

This process occurs in today's economy, without the existence of any substantial number of institutions that are known as consumer or retail banks. Now, if we add consumer banks to the

system nothing relevant has changed. The total amount of lendable funds has not increased, only the number of banks that are bidding for the public's deposits. The same thing is true on the lending side. The number of consumer lenders is increased but the total amount that will be lent to consumers will only be that amount which it is profitable to lend, given the cost of deposits and the interest rate consumers are willing to pay on consumer loans.

In considering this process, it is also important to note that family or consumer bank proposals allow them to devote substantial amounts of their assets to passive investments, including federal funds sales and commercial bank c.d.'s. This is intended primarily as a mechanism for liquidity investment, but it also gives these institutions the flexibility to adjust to shifts in demand for loans as described above. In other words, through such investments in commercial banks the family or consumer can channel part of their assets into the business sector as market conditions dictate. We also note that our own family bank proposal would authorize loans to small business, which was included to allay the fears indicated in your question.

Thus, the authorization of consumer banks will not increase the amount of consumer lending at the expense of small business. While this might have been possible under Regulation Q, when savers had no alternative ways to invest their savings and were compelled to leave them with depository institutions at low rates of interest, it cannot occur in a market that is governed by supply and demand.

The advantage offered to consumers by consumer banks is not an increased amount of bank credit but better and more individualized service from an institution designed to serve their needs.

8. As you know, part of the origin of the Glass-Steagall Act related to conflict of interest management. As a comparatively unregulated competitor with activities in both commercial lending and investment banking, could you please outline your company's technique for conflict of interest management?

A. To answer this, it is necessary to deal first with some implications in the question. In a very important sense, we are not a "comparatively unregulated competitor." Each of our companies that engage in investment banking and commercial lending of the type referred to in the question is intensely regulated under separate sets of regulations. We assume that what you mean by the phrase "comparatively unregulated" is that Sears is able to control companies engaged in each of these activities in a way that would not be possible for companies subject to the Bank Holding Company Act or the Glass-Steagall Act. But Sears does not control banks that make commercial loans, as bank holding companies do, so the comparison is not apt in this context because it was supposed conflicts involving commercial bank lending that led to Glass-Steagall.

I also wish to clarify what we understand by the term "conflict of interest" for purposes of this question. We assume that you refer to the suggestion that affiliations between commercial lenders (specifically regulated lenders entrusted with the management of funds contributed by the public, such as a bank) and investment bankers give rise to the temptation for the commercial lender to make unsound loans in order to shore up financially troubled clients of the investment banking affiliate, or otherwise to promote the business of the affiliate through such lending. As I am sure you are well aware, many experts who have studied the history of the Glass-Steagall Act have concluded that

there is no evidence that such abuses have occurred to any significant degree, certainly not to a degree that justifies the affiliation restrictions imposed by Glass-Steagall. For example, studies have shown that the banks that failed in the depression years were not the large banks that were the ones engaged in securities activities.

Although the bank that we control, Greenwood Trust Company, does not make commercial loans, a number of Sears companies are involved in providing financing for business enterprises in one form or another. As examples, a number of companies in our Allstate Insurance Group provide many forms of financing for business through portfolio investments, including corporate debt securities of various types. Many of our companies, including the Allstate Insurance Group as well as Sears Savings Bank, provide financing of real estate in all forms, including development and construction loans and permanent (long-term) mortgage loans, secured by the real estate. Many of our companies act as a broker or mortgage banker in arranging financing of these types. Our companies also engage in the purchase of commercial paper, as part of cash management activities. There are other examples, and this list is not exhaustive.

There are two basic types of structures that assure that there will be no financing provided to a borrower that would not comply with sound underwriting practices -- in other words, that protect against any improper influence traceable to the affiliation with Dean Witter. The first is regulatory. The commercial financing that is provided by regulated entities, which represents the overwhelming bulk of such lending done by our companies, is of course subject to strict regulations of various types. There are, first of all, important restrictions (and in some cases

prohibitions) on direct or indirect lending to affiliates such as Dean Witter. Beyond that, there are regulations and examination procedures concerning the quality of assets, and regulatory requirements for charge-offs for low quality assets.

The second structure, and one which as a practical matter may be even more effective, is that each entity is separately placed under the direction of responsible, experienced management that is made accountable for the achievement of business and profit goals applicable to that particular company. Quite simply, their careers are at stake. Each company develops its own internal lending procedures and practices, none of which specifies or implies any favoritism because of an affiliate relationship. Dean Witter and its clients are treated, in any financing proposal, at arms-length. No financings are made available simply to promote its business, and each transaction must comply with general underwriting practices. No direction (or even implication) is made from the headquarters at Sears that any transaction should depart from sound lending practices in order to favor Dean Witter or any other affiliate.

As a practical matter, it would be a rare situation in which it would make business sense for an unsound loan to be made in order to promote the business of an affiliate or its clients, because a possible gain to one entity would be offset by a loss to the other.

9. Mr. Volcker has said that, if "family banks" or "consumer banks" were authorized:

"...the regulated banking sector would inevitably wither and much of the banking business would take place in institutions not subject to the policy restrictions on

risk, conflicts of interest, and concentration of resources (that are imposed on full-service banks)". How would you respond to Chairman Volcker's concerns?

A. A short response to Mr. Volcker's statement is that "policy restrictions on risk, conflicts of interest, and concentration of resources" would apply to family banks or consumer banks themselves, as distinguished from their holding companies, in the same way as they would apply to all other banks. In fact, under our family bank proposal there would be additional restrictions imposed on those banks, such as higher capital requirements. To the extent that family or consumer banks would somehow not be subject to the same policy restrictions as other banks, we would support inclusion of these provisions in any proposed legislation.

With respect specifically to "policy restrictions on risk", we are not clear about what Mr. Volcker means by that phrase in this context, but we can think of no risk that would be undertaken by a family bank owned by Sears that would not be taken by other banks. Just the contrary is the case, because family banks would not be able to make commercial loans to large businesses or foreign governments, which we believe are more risky than the types of loans that family banks would be permitted to make.

We make the above points only to dispel any notion which is implied in his statement that family banks would be less regulated than other banks. We assume, however, that what Mr. Volcker has in mind is that if family banks were allowed to be owned by Sears or similar companies, then these banks would out-compete the "regulated banking sector" -- meaning the bank holding companies that are under the control of the Federal Reserve Board.

If that conclusion is correct, what it says is that the public is better served by diversified holding companies and will prefer to do business with these firms, rather than with organizations whose ability to meet consumer demand is restricted by Federal Reserve Board regulation.

No doubt Mr. Volcker believes that the Fed has good reasons to restrict bank holding companies. But the implication of his statement is that these reasons are so clear and strong that the public should forego the benefits of dealing with diversified financial services firms in order to preserve the health of institutions that the Fed is regulating. It does not say much for the efficacy of regulation -- and its effect on safety and soundness -- if the institutions on which it is imposed can only avoid "withering" by being freed of competition.

Mr. Volcker is asserting, in effect, that inequality of regulation would give an unfair competitive edge for the unregulated holding companies. If this is true, then which response is the best solution to the problem: increased regulation through exclusion of the diversified firms from competing, or deregulation of the bank holding companies to allow them to compete in a way being demanded by consumers? Our answer should be obvious.

Questions for Mr. Telling from Senator Reagle

1. What concerns, if any, do you have about the strength of the Federal Deposit Insurance System? What would be the effect of increasing the number able to offer deposit insurance?

A. In general, we agree with those who propose that the essential purpose and structure of the Federal Deposit Insurance System be re-examined, with a view to its reform. There appears to be a strong consensus, with which we concur, among economic experts and regulators that the present premium structure is mispriced, and permits depositories to operate with lower levels of capital and to accept higher risks than would be the case under a structure that imposes more market discipline in some form. We are not prepared at this point, however, to take a position on any particular proposals, such as risk based premiums, because we believe the entire subject needs further study to come up with a workable system.

In broader terms, the most fundamental threat that we see to the system is the possible failure to reform the regulatory scheme for financial services to permit depository holding companies to compete effectively. As indicated in a question from Senator Garn, the financial services industry is undergoing a revolution, and the traditional lines between financial service providers are blurring. If banks and other depositories and their holding companies are not permitted to respond to these changes, if they are confined to a narrow sector of the financial intermediary industry -- which in turn is only a narrow sector of the economy as a whole -- they may be forced to make riskier and riskier loans to weaker and weaker credits in order to remain in business. The result, ultimately, will be more and larger bank failures and increasing claims on the insurance system.

A comment is also in order concerning the role of holding companies in the reduction of risk to the insurance system. Mr. Volcker indicated in his testimony that we should restrict the activities of bank affiliates, along traditional lines. Yet one of the accepted purposes of holding companies is to serve as a source of financial strength for the subsidiaries, a purpose that cannot be effectively served if the holding company is essentially restricted to the same business as the depository itself is engaged in. In addition, the restrictive approach runs contrary to the widely accepted principle of reduction of risk through diversification. Diversified holding companies, such as Sears, could be a source of financial strength that would help relieve the pressure on the insurance system when additional capital is needed.

With regard to your question about the effect of adding numbers of insured depositories, we assume that you are referring to family or consumer banks. Whether the addition of new types of insured institutions will strengthen or weaken the insurance system obviously depends on the relative strength or weakness of the new group in comparison to the existing one. Family or consumer banks will be relatively stronger on average than commercial banks because consumer loan portfolios are generally less risky than commercial loan portfolios. In the case of family banks as we have proposed them they would also be stronger because of higher capital requirements (9% of assets) than presently required for FDIC insured banks (6% of assets). In addition, their diversified holding companies, such as Sears, are likely to be stronger than the restricted bank holding companies. Thus, the overall group of insured institutions should be relatively stronger than at present.

2. Please describe how you believe the regulatory structure would work if broader product and service authorities were authorized to all financial firms.

A. We favor a broadening of product and service authority principally through holding company affiliates. Under that approach, no fundamental change in the present regulatory structure is made necessary. In other words, each type of financial institution could continue to be regulated by the same agencies that presently regulate them. This includes preservation of the dual system of state and federal regulation of these institutions. The core business of each regulated company would determine the appropriate regulator. For example, if the institution offers government insured deposit accounts, it would be subject to banking regulation; or if it offers traditional forms of insurance policies, it would be subject to state insurance regulation; and so on.

Senator RIEGLE. Mr. Shipley, how big is Chemical Bank in rank order at the present time in terms of the major banks in the country?

Mr. SHIPLEY. We're the sixth largest.

Senator RIEGLE. I read the other day—and you correct me if this is not accurate—that the nine largest banks in the country, which of course would include yours then, have more than 100 percent of their net worth outstanding in foreign loans, and the story I read said foreign loans to just four countries, Brazil, Mexico, Argentina—

Mr. SHIPLEY. Argentina and Venezuela.

Senator RIEGLE. Is that correct?

Mr. SHIPLEY. Yes, sir.

Senator RIEGLE. Well, that makes a lot of us nervous. It may make you nervous. I hope it makes you nervous. But I think it relates to the question that Senator Proxmire was posing earlier. I don't know whether 14,000 banks or some number between 1 and 14,000 is the right number in this country but I think the concerns about consolidation as it's reflected by things like a substantial liability that hangs over our system now in foreign loans and a lot of them in places where they are not performing properly. It's one thing to sort of structure your work out where people are staying current on their interest payments and it's something else to have a sense of confidence that they're going to be able to repay the principal in any reasonable timeframe. I think that's a source of concern to anybody that pays attention to these issues and I just cite that because this discussion starts to work off in a lot of different directions if we're going to go toward some major consolidation of the banking system to a handful of banks.

Mr. Telling, I don't want you to feel lonesome. I used to work for Sears. You've been hearing from other committee members that worked for other companies here. But I used to sell socks and shirts in the men's department in Flint, MI, and I gather if I were still with Sears I probably would be selling financial services of various kinds.

Mr. TELLING. You probably would be sitting here.

Senator RIEGLE. Well, I'm not sure that's true. But in any event, I thought some of your suggestions were interesting in your testimony especially how you foresee the way a family bank should be structured with the kind of oversight and framework you thought should go around it.

ESTABLISHING CONSUMER BANKS

But let me ask you this. Paul Volcker testified here last week with respect to establishing consumer or family banks. He's not enthusiastic about that, as you probably know, and he said, "This concept would clearly undercut the basic public policies sought by closing the nonbank bank loophole," which of course he favors doing.

How do you respond to Chairman Volcker and others who oppose the consumer or family bank concept?

Mr. TELLING. First, I sensed a clear look in your eyes and I should have known you worked for Sears. [Laughter.]

I might add that 1 out of 30 of all Americans has worked for Sears at some time.

Senator RIEGLE. The other 29 shopped there? [Laughter.]

Mr. TELLING. It might say something about our turnover also.

But I can't agree with Chairman Volcker's statements at all and don't intend to. I believe that he represents the traditional banking industry and is intent on protecting that turf. He's forgotten completely, in my mind, the interest of the consumer. The consumer should have a choice of services as long as they are within a framework of safety and soundness.

Senator RIEGLE. Well, I think that's part of the question today. We're watching in Maryland, for example, a unique situation where we've got not just a run on the banks in process but also an emergency that's been declared and people that have their money in the State-supported savings and loans and insured savings and loans can't withdraw more than \$1,000 a month. This comes after the Ohio experience and I only cite that as an expression of the sense of confidence that people have about the system today and about the deposit insurance system and we've had problems in the Federal Deposit Insurance System. We had Ed Gray, who's the Chairman of the Home Loan Bank Board, in here yesterday and he has made proposals to strengthen the FDIC and the FSLIC insurance systems. I think it would be useful if all of you would respond to the issue—we're not going to have time to do this now because the vote has started—but for the record, do you share these concerns about the strength of the Federal Deposit Insurance System? I'm talking about the insurance system that gives the public that remaining confidence which results in having runs on the State-insured institutions in Maryland but not the Federal ones? God forbid that that should happen. It's happened before and it's happened in the lifetime of most of you at this table. So it's not something that's totally alien to our experience. And we don't want to revisit that.

I would be interested in any thoughts that any of you have on the Federal Deposit Insurance System; if we're going to broaden the number of people that come under that support system. However, understanding that it's the good faith and credit of the American Government that stands behind our ability to respond to depositor claims. I'd like to know how you see that system and its strengths. What more might need to be done if we're going to have a number of additional players that will have to stand on those Federal guarantees? We've got an awful lot of outstanding claims right now in this country, too many certainly in terms of the Federal deficit and the spending patterns we're on. And these are questions that I think are quite fundamental. The public is concerned; they have a right to have detailed answers and so it would help us if you could respond in those areas.

Mr. Chairman, let me yield at this point.

The CHAIRMAN. Well, I think we are all going to have to yield. We have about 5 minutes to cast a vote. So we will take a recess. [Recess.]

The CHAIRMAN. The committee will come to order.

Senator Dodd is next in line to question but while we are waiting for his return from the floor I will proceed.

Mr. Telling, in your testimony this morning you advocate the authorization of family banks. Last year we had a proposal originally in my bill known as consumer banks virtually identical to what you are proposing at this time.

And last week the Federal Reserve Board Chairman, Paul Volcker, had some comments about this particular proposal and I quote, he said:

If family banks or consumer banks are authorized, the regulated banking sector would inevitably wither and much of the banking business would take place in institutions not subject to the policy restrictions on risks, on conflicts of interest, and concentration of resources that are imposed on full service banks.

How would you respond to Chairman Volcker's concerns about family or consumer banks?

Mr. TELLING. Well, of course, Senator, we are consumer oriented and Mr. Volcker isn't, and our position is derived entirely from the consumers' standpoint. He is interested in protecting the industry and we are interested in protecting the consumer. A family bank is not a commercial bank; a consumer bank is not a commercial bank, and, of course, his interest lies with the commercial banks. I think that throughout our testimony we ask for no advantages. We insist on playing under the same regulations as everyone else. I think family banks should be regulated and they should be regulated evenly. I stated some of those parameters in my oral testimony.

I didn't get a chance to say earlier, Mr. Chairman, that as to your remarks following our remarks, I really wish I had said them or that you had given my remarks. It reflects our position almost to a T.

The CHAIRMAN. Well, if you want to trade salaries we'll switch remarks. [Laughter.]

Mr. TELLING. I thought I was a guest. I hadn't finished earlier when I said that being my age, I'm glad I'm sitting here and not there, and then I was interrupted. What I wanted to say was—that even 30 years ago I would also have preferred to be sitting here rather than there and if you want that salary 30 years ago we will trade.

The CHAIRMAN. Frankly, rather than either position, I'd rather be up there [indicating outer space].

Mr. TELLING. I told you I was jealous.

The CHAIRMAN. That is better than either, believe me.

Mr. TELLING. I'm sure it is. Are they going to put any 66-year-olds up there?

The CHAIRMAN. I'll put in a good word for you.

Mr. TELLING. My concern is getting there, not necessarily up in space, but getting there. [Laughter.]

The CHAIRMAN. Walter Cronkite is first on the list for the slightly older age group than mine.

Mr. Shipley, you very forcefully testified in favor of interstate banking. Interstate banking is at least partially already here. That is the reality of the marketplace. It isn't a question really of if we have interstate banking some day. It's just when. The politics of the situation are, I would be surprised if we could get 20 votes in the U.S. Senate for full interstate banking because of the fears across the country of concentrations of economic power.

It would obviously start with the two New York Senators and a couple of California Senators and so on and beyond that maybe there isn't even the other 16. So that's the political reality of it.

REGIONAL BANKING AS INTERIM STEP

My question is, recognizing that, regardless of what you may think is best to go to immediate full interstate banking and certainly Chairman Volcker wanted a trigger on interstate banking and there's a lot of sentiment for it probably a lot of places but not in Congress. And that is one of the reasons that regional banking is proposed and I view regional banking as an evolutionary step toward eventual full interstate banking. How many years down the road, I don't know, but quite a few. I do not expect the attitudes to change very rapidly on that.

Would you rather continue in the present environment with the inability to go directly to full interstate banking rather than have regional banking as a step in that process?

Mr. SHIPLEY. If I may, since you mentioned Mr. Volcker by name, make one comment so that you and the other members don't think that this panel is in total agreement. I would disagree with Mr. Telling as far as Mr. Volcker's objectives and his position. In my judgment, Paul Volcker has, and as far as I'm concerned probably always will, based on everything I know about him, act in what he believes is in the best interest of the country, the banking system, and our financial system. My apologies, but I thought I should express that view.

Mr. TELLING. I don't believe I impugned Mr. Volcker's Americanism. I hope I didn't. If I did, I apologize. But you didn't mention the consumer in your summation.

Mr. SHIPLEY. Having said that, I was the first New York bank chairman, to my knowledge, advocate a period of regional interstate banking to be followed by full national interstate banking. I continue to support that. I agreed 1 year ago to join the board of directors of the American Bankers Association as the only New York bank to do so in the belief that it was working to find answers within the banking system, as diverse as it is. Obviously, Chemical is different from a small bank in Wisconsin and from other banks represented on that board. It was in the interest of finding an avenue of harmony within the industry that I agreed to serve and, as a result, I do support, and have supported, the ABA's position which calls for a 5-year period to interstate banking though I would prefer a shorter trigger.

My concern for national interstate banking is for the industry primarily. Obviously, there is a parochial concern relating to Chemical Bank, but I believe that my own concerns for our bank should be secondary to concerns for the system as a whole.

I believe that our industry was built on some artificial economies, the four protectionisms that I recounted. We are in a different world today and I believe strongly that it is time to get on with consolidation. In a parochial sense, I fear that given the regional step without taking into account the need to go beyond will significantly reduce any political motivation to take the next step.

I have had discussions—I missed you because you were in training recently when I was here, but I visited with various other members of the committee. The political difficulty and the pressure that you are under, whether it's geographically from small banks, or from industries, or wherever it is from, is the basis of our frustration as we remember having been here 10 years ago in similar discussions. Very few people will disagree that interstate banking is desirable, but they will immediately debate timing, the sequence, the degree, and so forth. And most people will agree with some forms of product and functional deregulation in the banking industry, or the securities industry, or the insurance industry, or the retailing industry, but they will disagree with how far, how fast, and how it is controlled.

What I advocated is that this is too serious, and in my judgment too complex an issue, to be subject to the political pressures of the legislative process and that you consider, given very clear parameters of what you all believe and timeframes and with careful monitoring methods and controls, that you put the responsibility for effecting the change in the hands of a responsible group such as you did on interest rates.

I think the interest rate example worked well. We might argue in looking back at a particular point in time and place—

The CHAIRMAN. DIDC is not too popular with some.

Mr. SHIPLEY. I know. But sitting here today it is done and I think it's better having been done. If you tried to determine when you were going to allow money market funds and had to get that through the legislative process, I don't think it would have happened without DIDC.

The CHAIRMAN. Let me put your mind at rest before I turn to Senator Dodd in your comment about you didn't want anybody to think you all agreed here. I don't think anybody in this room would think you all agreed on everything.

Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman, and let me welcome all of you here this morning, particularly my good friend, Ed Budd, from Travelers.

Mr. Chairman, I have an opening statement I would just make available for the record.

The CHAIRMAN. Is it all right if I read it before I decide whether to include it?

Senator DODD. Just as long as it's in the record.

The CHAIRMAN. All of you need to understand the bantering that goes back and forth between Senator Dodd and I. We are very close friends. You wouldn't do that with somebody who was not. But by unanimous consent we will put your statement in the record.

Senator DODD. I would second that notion. I have enjoyed working with the chairman on a number of issues together and we have had good success in a number of areas.

STATEMENT OF SENATOR DODD

Mr. Chairman, I am delighted that you have invited such a distinguished panel to testify today. I believe they will be able to shed considerable light on the most recent developments in the financial

services industry—the rapid creation of new products and the increasing number of major financial disasters—which call out for congressional action to set the parameters for future development by the industries. At a minimum, I think we must act to eliminate deregulation by loophole. In addition, I think it is extremely important that we assess carefully the causes for the recent financial shocks so that we can determine the appropriate congressional response. The Congress must act to determine public policy here. That is not the job of the marketplace.

But let me return to the hearing at hand. I am extremely pleased that you have arranged for us to hear from a panel of outstanding leaders from among America's financial service providers. I am particularly delighted that we will be hearing from Edward Budd, chairman and chief executive officer of the Travelers Corp. In addition to being a major insurer, the Travelers is an excellent corporate citizen in Hartford and elsewhere. The Travelers has made an extensive commitment to the development and growth of small business and has developed an Older Americans Program that has brought major benefits to our senior citizens.

Mr. Budd himself has a long and distinguished career in the insurance business and with Travelers. In fact, this year he is celebrating his 30th year with the company. He not only heads up Travelers but he shares the company's commitment to making the community a better place for all our citizens. He serves as a director of a number of other companies and as a member of the corporate board of the American School for the Deaf.

Mr. Budd, welcome. I look forward to your testimony and that of our other witnesses, even of those gentlemen whose companies are not headquartered in Connecticut.

Let me go back to a couple of points with regard to the insurance issue particularly, one that, obviously, I have an interest in because of the amendment that was carried in the committee last year and on the floor of the Senate. I think it's important to make some distinctions but let me address the comment to you, Mr. Budd, because, obviously, that's where the colloquy emerged when I arrived here at the hearing this morning.

As I understand it, there is no objection whatsoever—there may be objection, but in terms of this particular body and our consideration if a State-chartered bank not affiliated with a bank holding company is able to convince its State legislature that it should be allowed to sell insurance in that State-chartered facility not affiliated with a bank holding company. That is not a matter of jurisdiction for this particular committee or this Congress. That is something to be dealt with on the State level so we are not involved in that issue.

I think there's been a fundamental misunderstanding of that point. What we are talking about is State-chartered banks that are subsidiaries or affiliated with bank holding companies which are a Federal creature. As a matter of public policy, we established sometime back under the Bank Holding Company Act that banks should not engage in insurance activities and that what we did with the legislation was to with this new phenomenon occurring, the affiliated subsidiary of a bank holding company emerging, merely tried to apply that policy as a standard of policy which Congresses over

the last number of years have adhered to and to apply it consistently so as not to establish a double standard, which is really the case. That was the double standard.

SAFETY, SOUNDNESS, AND RISK ISSUE

The second point—and I'd ask you to comment on a subject which some here on this panel I think have treated a bit too lightly, and I say that with all due respect, but the issue of safety and soundness and risk because at least in the mind of this particular Member of the Senate there are substantial differences in risks that are associated with various financial activities, some obviously being more risky in my mind, substantially more risky than others, and that that issue as well as the safety and soundness issue are what form the basis of the substantive policy decision historically.

I wonder if you just might comment on that and then I would like to ask Mr. Preston and Mr. Shipley why you disagree with my analysis on the issue of risks. You commented on it in your statement to some degree but I'd like you to respond to that.

Mr. BUDD. First of all, Senator, I agree with your interpretation of the States rights issue and the drafting of the Dodd amendment clearly accomplished the objectives of preserving to the States that area which you described and at the same time preventing the circumvention of the Federal jurisdiction in the bank holding company situation.

The matter of risk is a difficult one to address because indeed that's our responsibility, to manage risks. In an earlier draft of my testimony I had some words in it that I got nervous when I opened the newspaper in the morning. My staff said that's not becoming of a CEO to be nervous, you have to take that out, and interestingly enough, in the next day's newspaper in the business and finance section of the Wall Street Journal there were four articles: One had reference to Maryland officials being named conservators of Old Court Savings & Loan and Merritt Commercial Savings & Loan; another, that the Bevill Bresler collapse might have been prevented if regulators had acted on information that that group of security firms repeatedly violated certain rules; that Chemical in New York won't proceed with its plan with respect to the Ohio savings bank; that Lloyds of London said some syndicate members will have to pay a total of \$165 million to cover claims including asbestos claims. Well, as you know, Senator, asbestos liabilities go back for decades.

Other stories referred to authorities in Maryland working to contain a run and the dollar falling broadly while prices of precious metals jumped because of concerns about financial institutions in Maryland and Argentina.

So I do get a little nervous looking at the paper in the morning and I make phone calls about trading in Government securities, about accepting cash, about the use of the banking system in the way we may be processing our checks. So I'm not trying to overdo this, but I think the issue of increasing risks of a large financial institution, once you begin to integrate all those diverse businesses, is indeed one that we need to consider seriously. So we have to

work together with respect to whether or not the management and the regulatory mechanisms are indeed effective.

Senator DODD. Let me ask you, Mr. Shipley and Mr. Preston, to comment on that situation. I should probably go back and ask you—I don't know if either of you or your institutions maybe testified before the Congress at the time the Bank Holding Company Act was established and the proscribed activities were included and, if you did, did you support that legislation? If not all provisions of it, what conditions have changed in the ensuing years that should cause this Congress to take a different view with regard to the risk issue than we obviously did at the time that that legislation was adopted?

Mr. PRESTON. Well, Mr. Shipley is older than I am. He may have testified. [Laughter.]

Senator DODD. I quickly said your institutions.

Mr. PRESTON. I did not.

Senator DODD. It's not that long ago.

Mr. PRESTON. But I think that our institution did and was in favor of that legislation. The issue before us, Senator, is the terrific rapidity of change in markets around the world and there certainly are a variety of risks the banking institutions and the insurance companies have today that they didn't have at the time the Bank Holding Company Act was passed.

VOLATILE RISKS IN FOREIGN EXCHANGE MARKET

We are paid to manage those risks and there are risks in the foreign exchange market which are much more volatile today than when the Bank Holding Company Act passed, and there are risks in lending that were not present when the Bank Holding Company Act passed.

This country is going through reindustrialization and our typical client is having a terrible problem fighting the problem of imports and the competition from abroad. There are now world markets and there are world securities markets and it's ironic, as I mentioned in my testimony, that we can compete in those securities markets abroad, and many foreign banks can compete in the domestic securities market, but our bank is prohibited from competing in this market. It makes no sense to us. And to say that the status quo should be maintained with the passage of the Bank Holding Company Act ignores the technology revolution. It ignores all the testimony that virtually the entire table has given about the change in the financial services industry. We are all competing in one way or another and what we are trying to evolve is a sensible piece of legislation which will permit that competition on an equal basis, with proper regulatory supervision of new activities; we favor functional regulation.

I might point out that in terms of the problems in the Government securities industry, all the regulation in the world is not going to protect you against fraud.

Senator DODD. I agree with that.

Let me add a comment—as you were speaking, I can give you sort of a reaction to what you were saying before Mr. Shipley responds. It almost seems you were saying that there may be a case

that today it's a far riskier environment than when we originally adopted legislation. As you were talking, I agreed with you that it is far more complex. We are transferring sums of money with the speed of lightning which was not the case when this legislation was passed. There's a far broader investment opportunity which creates opportunities but in many ways, because of the nature of those investments, also heightens risk somewhat. That's my reaction. You can come back and comment on my own reaction, but I thought I'd share that.

Mr. PRESTON. Senator, you also should examine the benefits.

Senator DODD. I do that and I see they are substantial, but I am also looking at—our job, as you know—it's like preaching to the choir when I'm talking to you, but our job here is not so much the liabilities of your institutions, as important as that is, but the people we serve—that's our function—and to see to it that your clients and customers are being protected, that their investments of life savings or whatever else it is are going to be protected. I'm not suggesting—as I say, I'm preaching to the choir because all of you have that same interest, but in terms of our roles, ours is to see to it that we do everything possible not only to create an environment which allows individual institutions to be financially successful but the people you serve should also be protected, and the risk issue is one that I feel very strongly about and that more than anything else worries me, that sense of confidence and risk, and I see the kind of world we're living in and I think because those opportunities look so good out there—I'm sure Mexico, Argentina, and Brazil looked like very good investments and sound decisions were made at the time that major lending institutions decided to move in that direction. Obviously, we know that's not quite the case today. That kind of opportunity creates additional risks. That's what my own feeling is.

Mr. SHIPLEY. I agree basically with what Lew says, but let me take it a step beyond. The first comment I made was that we are trained risk evaluators. All of us in this business have gone through that learning process. And I think your question about risks is related to the Glass-Steagall as it pertains to potential deregulation and the exposure that that might place the depositors' funds in commercial banks in jeopardy.

Senator DODD. I should have been more specific, but that's right.

Mr. SHIPLEY. I would just point out that you have here two of the largest underwriters of Government securities in the United States and two of the largest underwriters of municipal securities in the United States. Lew has mentioned the involvement of all of us in the Euromarkets and the underwriting there and these are all activities closely monitored, very closely evaluated by the Federal Reserve and the State banking examiners. We are both State-chartered member banks and in the case of the nationally chartered bank monitored by the Comptroller of the Currency and the FDIC. The implication is that if we were allowed to be more broadly involved in underwriting securities that we would take on different risk parameters or philosophies in how we would manage our activities. I fail to see that there would be any difference.

Beyond that, what is happening in the marketplace is the tremendous evolution of such things as interest rate futures, interest

rate and currency swaps, and other financial instruments. The development of products such as these have actually contributed to reduction of risk exposure on the part of the major financial institutions of the world and if they are artificially precluded from participating in the broad sense in a marketplace it will be a disadvantage. It's like the Sears, Roebuck & Co. being allowed to sell white goods but not soft goods in their stores. That would be a competitive impediment to their ability to serve their client base. Diversity can be managed and monitored. You must be satisfied, the Fed and the other regulators must be satisfied, that should you broaden the product capability of the banks and others, that you have adequate functional supervision of those risks.

I spoke in my testimony, Senator, to the fact that we are suffering in our industry from what I called "equality of quality" through Federal insurance and that we must find ways for the market to be more sensitive and more knowledgeable about what risks are in individual institutions with which they deal.

Senator DODD. My time has expired and I read your testimony and in fact in my next round—so you can be thinking about it—one of my questions to you is that you did make that comment and I would be curious as to what recommendations or suggestions you might have if the FDIC issue creates a false notion of quality—what recommendations would you be making as an alternative to that. I don't think you really got into it in the statement.

The CHAIRMAN. Mr. Caspersen, you had some comments you wished to make?

CONSTANT CHANGE NECESSARY

Mr. CASPERSEN. Yes. I think it's very important to understand that there's oftentimes greater risks in not changing than there is in changing. If any institution had not made certain decisions 10 years ago and undertaken certain risks, any one at this table had not done that, we would not be sitting here today. There is a tremendous risk in not changing.

Senator DODD. I wasn't talking about that kind of risk. There's a distinction we ought to make. I was talking about the risk of what happens to deposits of consumers. Obviously institutions take risks all the time. Our concern here is not so much the kind—it is to the extent that the institution takes the risk that impacts on your customers' savings, and that's really what our job is. I just expect none of you to argue with me on that point. That's really our function.

The CHAIRMAN. Mr. Budd, did you have a comment?

Mr. BUDD. I never worked for the Government, but I sometimes think we have a profit-sharing arrangement around April 15. But I did have some actuarial experience, Senator, and maybe I could give just one brief example of the kind of thing we're talking about.

We look at the possibilities of an earthquake in our company from the perspective of a multiple line company in terms of insurance and also in terms of investment. We ask ourselves what's going to happen. Earthquake seems like a manageable risk because of the low probability and everyone's feeling it will never happen

to them. But it isn't just the earthquake and the buildings falling in. It's the fire that follows the earthquake and the worker's compensation exposure, the group life insurance exposure, the possibilities that hospitals won't function, and the impact on our investment portfolio. It's a very complex challenge to try to deal with all the risks.

Now we have also, in view of recent economic events, taken a look at things like what happens if oil goes to \$16 a barrel. Certainly we insure the people in the oil industry. Certainly we deposit in banks which have a lot of loans to oil companies. But then if you were to add on to that kind of risk assessment process the fact that we were a major banking institution with loans in the oil industry you pyramid a problem of risk analysis. That's genuinely real. That's the point I was trying to make before. I think the regulatory systems have just as much of a problem following the accumulation of risks as we do.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Telling, there's been a good deal of discussion in the debate over future banking legislation about your proposal for so-called family banks and I'd like to ask a few questions about how this new entity would fit in the existing competitive field.

Now Chairman Volcker indicated to us the other day that a lot of bankers already consider that they are running family banks and a number of independent bankers in small communities in my State would certainly say, well, we are a family bank.

Now let me just propose this question to you. Suppose there was very tough competition for depositors in a particular area, something like a gasoline price war, for example, and you were trying to get depositors to bring in funds in a town the size of Jackson, TN. It has a Sears outlet and a population of about 60,000. Now if there is tough competition for depositors, then clearly the consumers are going to benefit in the short term, but I'm wondering about the long-term impact of having as one of the competitors in this relatively small market an international corporation such as Sears, Roebuck.

How would the resources of the parent company be brought to bear in this local community, in other words, in shoring up your Sears family bank's ability to perhaps undercut the existing local or independent banker?

Mr. TELLING. Well, I would say first that in the same town that you mentioned where Sears is now operating, there are many, many small, independent merchants that are operating very profitably and that's really the pattern across the Nation.

CONSUMER BENEFITS FROM COMPETITION

We offer no threat. In fact, we might be an advantage to those communities as a merchant. Our reputation as a citizen in any community is well known. I think that the institution that offers the best service, the best product, at the best prices should be successful. That is competition and I don't draw any distinction between merchandising, banking, and insurance along that line.

As I said before, our interest is the consumer and he or she should be the beneficiary of all this competition.

Senator SASSER. Well, I don't know that that's going to do much to allay the fears of the independent bankers in the community of 50,000. What would you say to them?

Mr. TELLING. I was raised in a community of 35,000. My family were farmers and bankers. I don't know what my father is saying. I can imagine that he might be on the other side, but that doesn't make it necessarily right that the industry shouldn't be opened up to competition.

Senator SASSER. Well, there are some very attractive features about your family bank proposal. In reviewing your testimony—and I apologize to you and to all of you for not being here at the beginning of the hearing to hear your observations at the outset, but we have a custom here of scheduling committee meetings at the same time. I had to be at a meeting of the Defense Appropriations Subcommittee to hear the Army tell us how after increasing their budget about 40 percent over the past 5 years they still have shortages. So that's where I was.

But there are some attractive features in your proposal for a family bank from a consumer's point of view. I'm referring specifically—and I had a chance to review your testimony hurriedly—to the truth-in-saving provision where you propose to post the interest rate or dividend that will be paid on savings and also the so-called lifeline or no-fee minimum balance checking account. That's a very attractive provision, I would say, particularly for a lot of elderly people.

Do you think these standards that you outline for a Sears family bank if it comes to reality, should these standards be applied in the entire banking industry? Should they all have a truth-in-saving provision and should they all have lifeline or no-fee minimum balance accounts?

Mr. TELLING. Well, I think that's their decision. If I were a competitor, I certainly would be looking to match that kind of service. I don't want to imply that all small town banks are alike. There are many of them that provide a fine community service and are in a true sense family banks and serve in that way. But there are others, though, that tend to take deposits and to ship those to Mr. Preston and Mr. Shipley for a certificate of deposit in those communities.

Senator SASSER. One of the reasons that is given for not allowing consolidation of various financial services under one roof is that one branch of the house gets in trouble and then another falls into trouble, or perhaps the investment policies of one branch of the house get the other branch of the house in trouble.

Speculate for just a moment. Suppose you had a crisis at Dean Witter or a major problem in the Allstate Insurance Co. I don't wish any disasters on Sears and they are obviously not forthcoming—it's a good management company that's been around a long time and even people like Senator Riegle used to work for your company. But what would be the possibility in your mind of a run on a Sears family bank if we picked up the paper and we found that Dean Witter was in severe economic difficulty and the SEC was over there raising Cain, et cetera?

Mr. TELLING. There could be a run but I think the difference is that the doors wouldn't be shut and we would be servicing the customer as fast as we could by giving him his money. The industry needs more capitalization and I think that's apparent to all of us. Sears brings that to the industry. I just can't imagine the time that you would see long lines outside a Sears store or outside a family bank or where consumers weren't being serviced—either being given their money or depositing their money.

Senator SASSER. Well, as I say, there are some very interesting and I think attractive features in this concept that you are proposing. I still have some fear in the back of my mind of mixing all of these things up and a feeling that perhaps a weakness on one side of the operation may cause a severe weakness in the other side, but I do think your proposals are certainly worth exploring.

Mr. Shipley, if I might shift to you for just a moment, you say in your testimony there are too many banks. How many would you say is the right number and why would you arrive at that number?

Mr. SHIPLEY. Senator Proxmire asked this earlier, and I acknowledged that 13,000 was, in my judgment, better than 14,000, but I don't have a magic number. The point I was trying to make and the point I have been trying to make is that our industry is structured in a way that is less efficient than the banking industries of all the other countries that I know in the sense of operating cost efficiency including personnel, computer systems, and branch structure. The world is changing and it is changing rapidly. If it isn't companies such as this panel represents here today that are competitive, it is because of the blurring that is taking place among financial service, banking information, automation, and computers. There is a giant venture created between IBM, Sears, and CBS in the area of developing electronic delivery of financial services and products. This is the trend. Chemical Bank has a Pronto home information banking system. We have clients who access their bank account in New York City from Connecticut and from New Jersey through their home computer. They move money from their checking account to their savings account. They are able to electronically pay bills. They move money within Chemical Bank and outside of Chemical Bank, all highly legal and practical under all existing banking laws.

SYSTEM IS HIGHLY FRACTIONATED

My point is, the world is changing rapidly and we have a system that is fractionated, and very costly, and we should get on with consolidation of the industry. That doesn't mean elimination of banking outlets necessarily. I have said in other writings and speeches that I do not believe what the country needs is additional physical outlets. We have plenty of physical outlets for financial services in the country, but while Mr. Telling naturally can see an opportunity to create another physical outlet, I think if he had his way he would probably prefer to acquire a small bank in a small town rather than to open a new small bank in a new small town that is dealing with the consumers and small businesses. It's that line of thinking. I don't have any magic. Mr. Proxmire said that his analysis of efficiency in banking showed that there were effi-

ciencies only up to \$500 million. I would be interested to know if you took the total resources of the banking industry and divided it by \$500 million how many banks that would give us. Maybe that's a guideline.

Senator SASSER. Well, is there a percentage of national market share that might be the appropriate ceiling for a bank? We want to avoid an undue concentration of economic power—at least I do—and some have suggested a limit of 5 percent of all national bank assets would be a logical limit on a particular bank's assets. How do you respond to that?

Mr. SHIPLEY. That would potentially end up with 20 banks in the Nation and I would be surprised if anybody on this panel or on the committee would advocate that the industry be shrunk as small as 20.

No. 1, I think there's a great misconception that if tomorrow banking laws were completely done away with as far as geographical diversification, who would be buying whom. Chemical Bank has been involved, as most of you know, in trying to help the authorities in the State of Ohio find an answer to the home State bank problem in a way that doesn't detract from our existing activities. You can't take on many new additional activities like that. We cannot simply float stock and make acquisitions in an aggressive way.

I think there's a great misunderstanding as to what might happen should the barriers come down.

Senator SASSER. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dodd, I will give you the last question.

Senator DODD. Thank you, Mr. Chairman.

I would ask Mr. Shipley a question and I will give him a chance to comment on that one. Let me ask all of you something. I get the feeling in listening to you that there is maybe a question that we all should have asked at the very outset as to whether or not we ought to act at all. Should there be a piece of legislation come out of this committee in light of what's going on within the marketplace? Things are happening, whether we like it or not, and you are far ahead of anything we're really doing in many areas.

DEFINITE NEED FOR LEGISLATION

Let me just run down the panel. Should this committee act? Is there a necessity for legislation?

Mr. McELWEE. Absolutely, Senator. This committee should act and I think you could set forth parameters and certainly set forth fundamental principles that even as things change will be very helpful to the future.

For example, if you were to set forth principles which embraced the concept of functional regulation that will have a permanent and lasting effect. I would urge you to act as soon as possible and as broadly as possible.

Mr. CASPERSEN. At the present time in fact there is interstate banking, period. At the present time the consumer is being served by interstate entities, period. Citibank is servicing California. We are servicing Florida. In some form or another, everybody at this table is interstate. It is not in a rational mode. It is not completely

as regulated as it should be. If in fact this committee and Congress can come up with a rational, reasonable regulatory system that recognizes the changes in technology and the marketplace it will be vastly preferable to what occurs at this juncture.

Senator DODD. I can almost read that statement as saying we shouldn't act, if those are the parameters that are established. That's taking unprecedented action in 200 years.

Mr. SHIPLEY. Yes; I think you should act, but I repeat, I think it is an extremely complicated set of actions and I urge you to consider creating an entity to effect the deregulation of the system within parameters that you set. Set the parameters in broad time-frames along the DIDC parallel which I believe I have mentioned.

Senator DODD. Yes; it's in your testimony.

Mr. SHIPLEY. Yes.

Mr. TELLING. I can't say yes or no until I see the legislation. I'm a merchant. I have to see the goods first. But I would say that if it's just to be a quick fix or a patchwork, then I think it would be much more preferable to take no action.

Senator DODD. Mr. Preston.

Mr. PRESTON. Well, it seems to me, Senator, that there is a crying need for rationalization of the financial industry and I would recommend that it be taken before you are overwhelmed by change or possibly crises. And it seems to me that the regulatory problems which I think should be addressed shouldn't be addressed until this body has decided what the financial industry itself should look like and then you can sort out the regulatory problems. I think there are too many regulators, but we don't know what the financial industry is going to look like and until we do I don't see how we can address that problem.

Senator DODD. Thank you.

Mr. BUDD. I think, in looking at this, we all have to recognize that in spite of the frustration and the complexity and the inaction, there are a lot of things going on which do help the consumer. And so the failure to act isn't going to stop progress. I do think it is a frustration to all of us, as well as to the committee, that some parts of the situation are out of control and I would certainly urge action which clarifies that situation. But in view of the things that are ongoing and the complexity of it, I don't know how, you can proceed logically and responsibly without looking at both the issue of how you would like to see the financial services industry structured and then how, indeed, that will be managed from a regulatory standpoint.

So I think the challenge still remains very great and we have a great respect for your responsibilities in that.

Senator DODD. Let me just ask one other question. I will ask Mr. Preston and Mr. Shipley and then you can comment on the earlier question that I raised about Federal deposit insurance.

Can you identify for the committee areas of investment that you think would be so inherently unsafe that banks should be prohibited from investing in them? Are there any areas? You've constantly brought up things that you've said you ought to be in. In your own mind, are there other areas that you should not be in?

Mr. PRESTON. Well, I think I would come at that a little differently, Senator. I would think that the various activities which we

have talked about and perhaps some others should not be left to a decision by the States. In the case of real estate, in New York State, we are permitted to invest 5 percent of our assets. Now, 5 percent of our assets is about two-thirds of our capital. I don't think that the Morgan Bank should have two-thirds of its capital in the real estate business for liquidity reasons if no other. So I think that to prescribe some percentage limit on real estate investment would be a constructive thing. I think the problems in the thrift industry bring that home today.

Mr. SHIPLEY. Our particular interest is broadening ability to compete in the broad area of financial instruments. This is, I think, the main thing we are talking about. I would agree with Lew on the question of unrelated activities; and that there are limits and we can talk about those. I agree that three-quarters of capital in real estate is probably not appropriate. But mainly we want to provide a broader array of financial instruments domestically, such as we are able to do abroad.

Senator DODD. There aren't really any parameters?

Mr. SHIPLEY. On financial instruments.

Senator DODD. There should not be any parameters, there's no area within financial instruments that you consider so inherently unsafe?

Mr. SHIPLEY. No; I wouldn't go that far. Let me give you a Chemical Bank example because it's an appropriate and current issue. Investing is a broad word. Investing is lending. Investment is buying. Chemical Bank does not finance corporate raiders. It does not finance greenmailers. Chemical Bank does not invest in junk bonds nor do we lend to individuals that take junk bonds as collateral.

Now those are judgments that we make. Whether those are judgments that should be arbitrarily imposed upon an industry or a bank or a segment of industry, I have very serious questions.

TWO WAYS BANKS GET INTO TROUBLE

Banks get into trouble in two ways that I know of. One is through looseness in lending activities, their overaggressive lending in the sense of quality and price of which we have had some major examples; and the second is through loss of management control of risks being taken in various areas, and I talk about risks at multiple layers through the organization. We focus on making absolutely sure that at every level of the organization the manager understands the totality of risks being taken, not just the obvious ones, and that is part of the process.

When you ask what instruments one should be allowed to trade, it has to be related to the risks of that particular instrument and the degree of control. We have a very complex and thorough system of evaluating the quality of financial institutions, both from a regulatory point of view and from a free market point of view. All of us are evaluated publicly by Standard and Poors, by Moody's and by other rating agencies and you can go to the book and find how each bank is rated.

In answer to your earlier question, not everyone will agree, but I am an advocate of premium variability of FDIC insurance based on

quality, and I think that would be a step in the right direction on this "equality of quality" issue.

Senator DODD. Thank you and thank all of you for your patience this morning.

Mr. Chairman, thank you very much.

The CHAIRMAN. Gentlemen, thank you for your patience. Let me just close by saying once again that I think now is the time to enact a broadly based bill and interestingly enough the bill we passed last year was not very broad. To the opponents of further deregulation in powers you would think it was the entire dismantling of Glass-Steagall. I hardly think that municipal revenue bonds and mortgage-backed securities fit into a definition of destroying Glass-Steagall. And that's all that bill did—two new powers—it legalized what you're already doing in commercial paper and discount brokerage, but only two new powers were granted. Mortgage-backed securities did not exist at the time Glass-Steagall was written. As a matter of fact, they are relatively new. And municipal revenue bonds were virtually nonexistent at that period of time and the framers of Glass-Steagall saw fit to put general obligation bonds in. I want to leave that thought once more. I keep trying to indicate that this is hardly some great break in Glass-Steagall with two new powers.

The second thing I would like to say in closing is that I certainly share Mr. Budd's feelings about reading the newspapers and as chairman of this committee I read them carefully. I have briefings. I hear from the regulators all the time. And it is frankly a frightening situation we live in with the international debt structure, energy loans and all sort of things, and we are in a very difficult period and have been for several years and we will be for a few years into the future.

As much as I am concerned about that, however, I get a little bit tired of those who wish to protect their own turf of using that safety and soundness issue as a reason for not only not going to further deregulation but talking about reregulation. And yet in response to challenges, I have yet to have anyone show me that any of the bank failures that have occurred or savings and loans have occurred as a result of what new powers they have been given or what is proposed to be given.

The most notable examples, you look at the Jake Butcher situation in Tennessee. It's fraud. It has nothing to do with powers or anything else. If you look at Penn Square, you've got the same elements there. It was a small bank that I think the regulators didn't follow up carefully enough and rapidly enough, involved in energy loans and growing from a very small neighborhood institution to in excess of \$500 million virtually overnight, had nothing to do with municipal revenue bonds or a traditional retail banking base. They didn't have one. And the most recent example of Continental Illinois—and I've heard that—"Oh, good Lord, you wouldn't want to give anybody more authorities. They can't handle them now." Continental Illinois was not a family bank. It was a commercial bank in the truest sense of the word operating in a State that did not allow them to branch across county lines. I mean, forget the argument about across State lines, no branches. So, yes, they became a very large international commercial and domestic bank with no

retail deposit base at all. I just want to make that point once again for the record, but I will still hear it again. The safety and soundness issue is real, no doubt about it, and that is our primary responsibility, as Senator Dodd points out. I agree with him. We need to protect those depositors. I think that is our fundamental responsibility here.

You gentlemen take care of yourselves in the competitive world. It is not our place to guarantee you a profit or a place in the world or not to have the opportunity to fail if you screw up in your decisions. Our responsibility is to the depositors and the public. But I want those people who continue to make that safety and soundness argument on other grounds to come up with an example to show me that Continental Illinois, or Penn Square, or other banks have failed as a result of what we are talking about.

I would go back to what you're saying, it would lessen some of the risks involved if we do it carefully and thoughtfully. I happen to think that the Continental might not have gotten into trouble as they did if they had had a retail base and Illinois had been enlightened enough to let them operate throughout all of Illinois rather than just Cook County.

Gentlemen, thank you very much. We appreciate your testimony. The committee is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY PART I

WEDNESDAY, MAY 22, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, and Dixon.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This is the fourth in our ongoing hearings on changes in the financial services industry. Today our panel includes a group of consultants to the industry.

Gentlemen, I'm sure you are aware that I have repeated over, and over, and over again that comprehensive banking legislation is needed to address the rapid developments in the financial services industry. I was interested that in your testimonies to note that you all recognize the multifaceted nature of these changes which I believe supports my contention that a simple loophole closing will only result in the continuation of the haphazard process of change that appears to be going on today.

While I am not wedded to any particular piece of legislation, I am absolutely committed to the notion that comprehensive legislation provides for a measure of functional regulation throughout the industry and is absolutely necessary.

I am very interested in hearing your thoughts on this subject today and our first panel includes James McCormick, who is president of the First Manhattan Consulting Group, consultants to many institutions throughout the industry; Mr. Lee Gunderson, a partner of Arthur Young & Co., and director of their banking industry relations practice; and Joel Friedman, a partner of Arthur Andersen & Co., who is in that firm's management consulting division which specializes in the financial services industry.

Our second panel includes Lawrence Connell, the president of Washington Mutual Savings Bank and well known as the past president of the National Credit Union Association and Connecticut State banking commissioner; Lawrence Evans, chief operating

officer, Acacia Mutual Life Insurance Co. here in Washington, a diversified insurance holding company.

Finally, our last panel includes Douglas J. Timmerman, currently serving as president and chief executive officer of Anchor Savings & Loan Association of Madison, WI, formerly professor of business at the University of Wisconsin; and C.E. Bentley, chairman, United Financial Group, who's the parent of United Savings Association of Texas, who is here from Houston.

Gentlemen, if the first panel will come up—Mr. McCormick, Mr. Gunderson, and Mr. Friedman—we would appreciate it.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. I'd just like to welcome—I think this is a fine panel but I would particularly like to welcome Lee Gunderson. It says here you're a partner of Arthur Young & Co., New York City. New York, I can't believe it. Lee Gunderson is from Wisconsin, we are very proud and happy to say, and he did a marvelous job as a president of a bank in Wisconsin. He was president of the American Bankers Association, a very, very distinguished banker. Wisconsin has given two outstanding bankers to this country, one Walter Wriston and the other one is Lee Gunderson. Lee Gunderson is No. 1 and Walter Wriston is No. 2.

Mr. GUNDERSON. Thank you, Senator. That's pretty heavy company.

The CHAIRMAN. I don't know anybody who would want to leave Wisconsin for New York either.

Senator Mattingly.

Senator MATTINGLY. I have no statement, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I have given you a prepared text and I would ask that my statement be placed in the record as though read in full.

The CHAIRMAN. It will be so entered.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its oversight hearings on changes in the financial services industry. We have a distinguished panel of witnesses before us, and I look forward to hearing their testimony.

These are turbulent times for many of our financial institutions. State thrift insurance systems in Ohio and Maryland have proven to be inadequate to preserve depositor confidence. While the banking industry as a whole is profitable, bank failures are at a higher level than any time since the Great Depression, something that is almost incomprehensible in the third year of an economic recovery.

There are numerous problems that need legislative solutions. Questions involving nonbank banks, new bank asset powers, regional interstate banking, deposit insurance reform, and thrifts and the FSLIC fund, to name just a few, all need to be addressed.

As I have stated before, however, while I believe all pending issues should be addressed, I do not believe it would be wise to at-

tempt to handle them all in one bill. Some of the issues are new, and will take further analysis before the committee is ready to legislate. Other issues, such as those contained in the bill reported by this committee last year, can be resolved much more quickly.

I hope the committee will consider a two-bill approach, therefore, and that we will quickly act on a bill covering the issues raised in last year's bill, and then go to work on the new issues. We cannot afford to go another Congress without enacting major banking legislation. Acting quickly will help maximize the chances for passage of one or more meaningful bills.

The CHAIRMAN. Thank you, Senator Dixon.

Senator D'Amato.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, good morning. Before I begin I would just like to commend you for conducting this series of important hearings on competitive equity in the financial services industry. I also would like to thank the witnesses for taking time from their busy schedules to participate in the Senate Banking Committee's oversight hearings on the financial services industry.

The current financial system in this Nation is showing severe signs of strain. Recently, there has been a great deal of rumbling in the financial community on a wide range of issues, including the foreign loans to developing nations, the disturbances in the Government securities market, and the recent failures of savings and loans in both Maryland and Ohio. This has given those concerned with the well-being of the financial industry reason to worry.

There is a definite need to stabilize the financial industry. I believe this set of hearings provides an adequate examination of the industry and can be used to provide a safer and more equitable system.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McCormick, would you like to begin?

STATEMENT OF JAMES M. McCORMICK, PRESIDENT, FIRST MANHATTAN CONSULTING GROUP, NEW YORK, NY

Mr. McCORMICK. Good morning, Mr. Chairman and members of the committee. My name is James McCormick and I am president of the First Manhattan Consulting Group of New York City.

You have asked me to address the forces at work in the banking industry. This statement presents a perspective from, say, 40,000 feet. We have chosen this altitude because it enables one to take a farsighted view. Any higher up, say orbiting hundreds of miles above the globe, and I would be outside my realm of experience. So far, there's only a very few of us—such as Senator Garn—that can claim that they literally have taken a global perspective (reference to Senator Garn's space shuttle trip).

This statement basically makes the case that legislation should smooth the transition to more efficient formulas for intermediation.

PERIOD OF FUNDAMENTAL RESTRUCTURING

First Manhattan Consulting Group believes that the current turmoil in the banking industry represents only the beginning of a period of fundamental restructuring, and perhaps dislocation. This restructuring will result from healthy market forces that will drive the industry to more efficient use of its capital.

We feel that legislation cannot prevent these market forces from precipitating change, nor should legislation attempt to alter the direction of the change, because this direction is in the interests of the public good. That is, both borrowers and investors will be better served. I will make the case that this goal can be best accomplished as banks shift their focus from asset and deposit growth to a form of intermediation that requires less equity, and is therefore delivered at less cost to the customer.

We feel that legislation should focus on facilitating the transition and minimizing disruptions from the public's perspective. We believe that this will require elimination of constraints that preclude banks from evolving into more efficient intermediaries. Failure to provide relief will relegate banks to an outmoded method of competition and will likely lead some banks to take greater risks causing further bankruptcies, threats to public confidence, and drains on FDIC reserves.

Of course, we do not believe that Congress must act only to prevent bad consequences for banks. We feel that focusing the legislative process on allowing banks to adapt to market forces will simultaneously meet the goals of increasing efficiency, fostering innovation, and enhancing safety and soundness.

Why do we assert that banks need to transform their approach to financial intermediation? First Manhattan Consulting Group's perspective is based on five beliefs.

First, banks financial performance is now poor, and has been continuously sliding for 20 years. This is characteristic of an industry in decline. The cause of the decline is healthy innovation from nonbank competitors—a powerful market force. This competition has pierced banks' oligopoly position. At the same time, regulatory constraints on banks have precluded them from updating their approaches to this competition.

Second, the financial institutions that prosper in the 1990's will have very different characteristics from today. Basically, the transformation will be driven by the fact that securities are intrinsically more efficient than bank deposits and loans in meeting the needs of an increasing number of market segments.

This is because putting borrowers and investors together through the vehicle of a security can be accomplished by an intermediary with less equity than a bank would require to serve borrowers using loans and investors providing deposits. Overall profits necessary to provide a return on equity employed by the intermediary are therefore less and spreads can be thinner. This gives the borrower a lower cost source of financing and the investor a higher yield source of investment than banks can provide. There are numerous examples of markets shifting to this more efficient form. Best known are commercial paper and mortgage-backed securities as alternatives to bank loans and money market accounts as substi-

tutes for deposits. For example, our analysis indicates that mortgage rates are lower now because mortgages are increasingly securitized rather than put on the books of a bank-like institution. Banks could provide these services themselves, if they were permitted to do so. In fact, because banks arguably have the broadest access to borrowers and investors, they could introduce this more efficient form of financial intermediation to customers who have not yet been able to benefit from it.

My third point is that this transformation of the financial structure of banks will be healthy for customers and for the economy. This is because the market forces creating this change are those of efficiency and innovation. Also, if banks were allowed to respond to these forces naturally, we feel that safety and soundness would be enhanced, not reduced.

Fourth, new legislation is needed to capture the benefits of this more efficient method of intermediation and enable a smooth transition. Farsighted legislation will be critical to mitigating the risks that could result from banks increasingly being at a legislated competitive disadvantage as these market forces increase. Without deregulation that acknowledges the inefficiencies in the approach that banks are restricted to use today, some banks may increase lending or interest rate risk in an effort to try to obtain acceptable returns on their shareholders' equity.

Finally, this period will require many banks to walk a tightrope between risk and return while the restructuring is underway. Therefore, we feel that bank supervision should be temporarily bolstered to better define and measure two types of risk: credit risk and asset/liability maturity risk.

Let me explore each of these five points in a bit more depth.

BANK FINANCIAL PERFORMANCE IS POOR

First, banks financial performance is now poor and will continue a 20-year decline unless constraints are lifted.

The trend in banks' financial performance suggests that the industry is far from healthy. In fact, by some financial measures, banking is one of the worst performing industries in the United States. Perhaps this is surprising to some laymen and legislators. Of all the industries in America, including the so-called smoke-stack and rust bowl industries, banking is one of the worst off at this time. Exhibit A shows the results of our analysis of data provided by Business Week last year. It shows that the market value of the top 30 banks, divided by their common equity, averaged around 60 percent in the middle of 1984. This was substantially below that of any other industry, including such mature industries as steel, tire and rubber, and mining.

What does this mean? Academic literature and empirical research stresses that one of the best leading indicators of future financial condition is a firm's stock price relative to the book equity invested in it. Therefore, interpret these findings as strong indication that the markets believe that many banks are going to be forced to restructure. That is, either they must fundamentally change their strategy or redeploy their equity.

Why should we be concerned about banks' financial returns to their shareholders? I do not believe there is any reason why Congress should indefinitely subsidize banks. But it is important for Congress, if it can, to enable financial intermediation to be efficient and to make the process of transition as least disruptive as possible.

While the committee might have no specific concern for the owners of bank stocks, it is important that it recognize what this poor financial performance does imply. Let's say a bank has a market-to-book value of 60 percent—not at all atypical today—and reinvests \$100 million in retained earnings. At 60 percent market-to-book, the capital markets transform this \$100 million into stock with an economic value of only \$60 million. Thus, \$40 million is destroyed by reinvesting the \$100 million into the bank. The degree of pessimism implied by this, as the capital markets look at banking—and the capital markets are the most efficient forecasters we know—is that they are saying the banking industry is in severe trouble and is investing capital where on average inadequate returns are being made. An inadequate level of return indicates an industry in decline, producing products and services that are either unwanted or too expensive relative to competitors products.

Nor is the traditional banking business encountering a short-term dip in performance. As is indicated in exhibit B, the top 30 banks have seen a steady erosion in their returns on equity over the past 15 years.

This poor financial performance is not surprising when one realizes that their traditional formula for financial intermediation is outmoded. Basically, we feel that banks formula is too balance sheet intensive, arising from the fact that investors do not invest directly in the credit issued by borrowers, but instead make deposits in the balance sheet of a bank which issues credit as loans.

This approach requires that the bank cover some 5 percent of the credit given with equity to meet regulatory requirements. This is inherently less efficient than if the credit were directly owned by investors, since spreads have to be wider to provide for a return on the equity invested in the intermediation. Stated another way, the most efficient form of intermediation is one that requires the least equity to perform its function. Equity should only be prevalent when the risk it covers cannot be diversified through other, more efficient means.

Thus, when we look at the banking industry, we see all the conditions of an industry that is going into a restructuring phase. This restructuring, of course, is already upon us in the thrift industry. The thrifts formula for intermediation was cannibalized by substitute products; they reacted by taking on massive mismatching risk. Recently, some people have asserted that the industry as a whole, comprising almost \$1 trillion of assets, is essentially bankrupt. This has not happened because of deregulation, but because the thrifts traditional formula became less attractive to customers than alternatives offered by competitors.

Our view of the banking industry suggests that the same process experienced by the thrifts is underway in commercial banking. There are two major trends which make this true.

First, on the deposit side of banking, money market funds, for example, represent a more efficient vehicle for investors. These funds require relatively small amounts of capital to offer savers a market rate of return on what are in effect consumer deposits. Without a need to charge additional spreads to provide returns on equity that would be otherwise required if these were deposits on a bank's balance sheet, these funds are able to offer higher rates of return.

The growth of this instrument is only the most publicized alternative to banks' options for investors. For example, last Sunday's New York Times published a section entitled "Personal Investing." This 72-page guide to personal financing planning contained counsel from advisers, articles on investment alternatives, and advertisements. It was interesting to note that of 14 articles on financial instruments, none discussed instruments offered by banks; of the 50 advertisements aimed at the investing public, only 4 were for bank instruments; and in the commentary where financial advisers were asked to counsel households of different life stages and financial means, they recommended direct equities, mutual funds, municipal tax-free bonds, real estate, et cetera, but in no instance did they recommend depositing money with a bank.

SECURITIZED DEBT

On the asset side of the banking equation, borrower's debt that was heretofore financed through bank loans is increasingly being securitized. For example, commercial loans are being replaced by commercial paper and other forms of securitized debt. In consumer financing, mortgages are increasingly securitized. Just as with the money market funds, these instruments require very little capital on the part of the intermediary. Consequently, they can be delivered at lower cost and pose far less risk since the risk of default is accepted and typically diversified by the purchaser of the security or through other means.

Is this a short-term phenomenon? Are these the only instances that we will see? We feel the answer to both these questions is no. Essentially, an innovative financier that can remove loans from a bank's balance sheet and package them as securities has about 140 basis points, or a 1.4-percent spread, of cost advantage to play with. That is, by converting the loan to a security, the financial engineer eliminates the needs for most of the equity and other liquidity assets to support the loan and makes the process more efficient.

Thus, the new game is clear and the number of financial innovators that are peering into the asset side of banks balance sheets are many. And why not? They are looking to make a market more efficient and at the same time earn the high rewards that are typically prevalent in the early stages of industry transitions.

Thus, these new formulas are already winning out, and we believe they are intrinsically more efficient. That is why we say the bank formula of intermediation is increasingly outmoded.

Will all loans be securitized over time? We feel that the answer here is no. In general, securitization of classes of loans will occur when the risks can be managed more efficiently in security form. Financial innovators are continually figuring out new ways to accomplish this, diversifying risks in new ways.

The concept of an industry in decline should be familiar to the committee. If banking does not adapt, there is absolutely no reason why it should not have a life cycle just as the steel industry did, the textile industry did, and the tire and rubber industry did. If banks are permitted to transition into new forms of intermediation within the broader financial services industry, then the transition will be less severe in terms of customer dislocation. By analogy, imagine if regulation precluded the major U.S. tire companies from evolving to radial tires from bias ply.

We believe that banks can, if allowed, evolve to meet the needs of many investors and borrowers in a more efficient way. Left to their own devices, we feel that successful banks would naturally evolve into these more efficient methods of meeting needs.

Let's take a few examples. Imagine a wholesale-oriented money center bank that increasingly converts its loans into securitized instruments. That is, it sells off many of the loans it originates and, if permitted by deregulation, structures some of the loans it originates into securities backed by pools of corporate debt. One day it announces that it is repurchasing, say, two-thirds of its common equity, dramatically reducing the size of its balance sheet, and emerging as a new form of merchant bank that is more efficient, capitalizing on its debt origination, structuring, and placing skills.

Similarly, imagine a consumer-oriented regional bank that over time offers consumers access to investment funds that have liquidity, maturity, and yield characteristics similar to existing types of deposits. Over time this bank liquifies the asset side of its balance sheet as well. One day it announces a repurchase of a significant portion of its equity, and transitions to a mutual fund-type structure with a brick and mortar retail distribution system.

We feel that this type of transformation will, if permitted, occur within the next 10 years.

In addition to satisfying goals of efficiency and innovation, safety and soundness will be improved. The level of deposits requiring FDIC insurance will decline. The pressure to take imprudent risks in a vain attempt to obtain an acceptable return on equity in the outmoded formula will be reduced.

This evolutionary formula will of course have to deal with risk. We feel that credit risk can be broadly diversified through the use of securities. It can even be further diversified if mutual funds holding a portfolio of securitized instruments emerge. Further, credit risk can be publicly insured, as entities such as specialist insurers in municipal credit enhancement have demonstrated.

Further, interest rate risk can be stripped out and sold as a separate instrument, or hedged using new forms of financial futures.

Thus, these market forces are in the best interests of most parties concerned. I say most, because if regulation does not provide a way for banks to react to these forces, dislocations could be severe, as has been the case with thrifts.

Existing legislation and regulation has defined how banks and nonbanks may compete in meeting the funding needs of businesses and the investing needs of the public.

BANKS ARE NOW BOXED IN

In our view, banks are now boxed in. Because of these market forces, they cannot continue to perform the roles allotted them by legislation without increased risk to their shareholders and ultimately to depositors.

Capital adequacy exemplifies the problems associated with taking steps to protect the viability of an outmoded formula. Forcing banks to increase their primary capital ratios is seemingly in the interest of safety and soundness because capital ostensibly provides a cushion to absorb risk. However, since banks are no longer an oligopoly, they cannot pass on the extra cost of increased capitalization to their customers. For example, in the case of a money center bank trying to earn 16 percent on its equity, if it is capitalized at 6 percent versus 4 percent common equity to assets, it will need to charge approximately 60 basis points more on all its loans. That is, that 140 basis points that the financial innovator has in his pocket when he takes a loan and converts it into security now becomes, instead of 140 basis points, a 200 basis point advantage. This disadvantage impacts all banks.

Of course, if banks try to raise spreads on existing loans, more market segments will be subject to inroads by nonbanks offering credit via securitization. This could in turn force banks to look for spreads from increasingly risky borrowers. If they do, these banks will be riskier themselves. This outcome runs counter to what we are looking for by requiring more capital. Another way that more risk could be taken on would be through interest rate risk and that might not be prudent either.

What else can banks do? They need returns on the equity required by their formula for intermediation.

In pragmatic terms, this suggests further deregulation. This is warranted now because the mainstream businesses of retail- and corporate-oriented banks are under attack today.

Finally, we feel that regulators should improve their approaches to identifying and monitoring risk during this period when banks will be walking a tightrope. By risk, I refer to credit risk and interest rate risk, rather than to capital risk, which as we discussed above, we believe is a false issue at today's level capitalization.

We believe that great improvements have been achieved in banks' assessment of credit risk. However, in our experience, the process of pricing loans is far from efficient or at times logical today. So there is still room for improvement.

Also, in the area of interest rate risk, we find the situation quite confused. For example, in our travels, we find that the notions of liquidity risk and repricing risk and how to measure each vary widely from bank to bank. We feel that regulators could provide some thought leadership to help many banks in this area.

In conclusion, we believe that the forces at work which I have described are desirable, when viewed from the overall perspective of what is good for the economy and for the people. All the changes that I have described create greater efficiency, lead to considerable product innovation, and ultimately result in greater safety and soundness for the industry. The legislative process should support any trend that brings better products and services to the customer

at lower cost and makes it easier and cheaper for American industry to finance itself.

In summary, Mr. Chairman and committee members, the thrust of my argument is that the banking industry is in trouble because market forces and innovation are creating better, substitute services.

Legislation should not attempt to reverse this. It is unlikely this trend can be altered. Instead, farsighted legislation could enable the best banks and nonbanks to craft new financial institutions that will emerge to serve customers and industry more cost effectively with equal or lower risk.

I thank you very much for the opportunity to discuss this important subject today.

[The complete prepared statement follows:]

First Manhattan Consulting GroupSTATEMENT OF JAMES M. McCORMICK

President
First Manhattan Consulting Group
New York, New York

THE NEED TO TRANSFORM BANKS INTO INTERMEDIARIES THAT MAKE MORE EFFICIENT USE OF EQUITY

Good morning, Mr. Chairman and Members of the Committee. I'm honored to have the opportunity to speak before you. My name is James M. McCormick, and I am President of First Manhattan Consulting Group.*

Introduction and Background

The perspective I am presenting for your consideration today reflects both my own views and those of the senior partners of First Manhattan Consulting Group. It is derived from our analyses of the financial services industry and the experience we have gained in over 350 assignments where we have consulted on behalf of commercial banks, investment banks, insurance companies, brokers, investment managers, and diversified financial services companies.

Legislation Should Smooth the Transition
To More Efficient Formulas for Intermediation

First Manhattan believes that the current turmoil in the banking industry represents only the beginning of a period of fundamental restructuring, and perhaps dislocation. This restructuring will result from healthy market forces that will drive the industry to more efficient use of its capital.

We feel that legislation cannot prevent these market forces from precipitating change, nor should legislation attempt to alter the direction of the change, because this direction is in the interests of the public good. That is, both borrowers and investors will be better served. This will be accomplished as banks shift their focus from asset and deposit growth to a form of intermediation that requires less equity, and is therefore delivered at lower cost to the customer.

* - Note: First Manhattan Consulting Group is an independent management consulting firm. It is not affiliated with First Manhattan Company, the investment management firm.

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We feel that legislators' primary focus should be on facilitating the transition and minimizing disruptions, from the public's perspective - both consumers and corporations. We believe that this will require elimination of constraints that preclude banks from evolving into more efficient intermediaries. Failure to provide relief will relegate banks to an outmoded method of competition and will likely lead some banks to take greater risks causing further bankruptcies, threats to public confidence, and drains on FDIC reserves.

We do not believe that Congress must act only to prevent bad consequences for the banking system. We feel that focusing the legislative process on allowing banks to adapt to market forces will simultaneously meet the goals of increasing efficiency, fostering innovation, and enhancing safety and soundness.

Why Banks' Need To Transform Their Approach As Financial Intermediators

First Manhattan's perspective is based on five beliefs:

1. First, banks' financial performance is now poor, and has been continuously sliding for 20 years. This is characteristic of an industry in decline. The cause of the decline is healthy innovation from non-bank competitors - a powerful market force. This competition has eroded banks' oligopoly position that was ostensibly protected by regulation. At the same time, regulatory constraints on banks have precluded them from updating their approaches in reaction to this competition.
2. Second, the financial institutions that prosper in the 1990s will have very different characteristics from today. The transformation will be driven by the fact that securities are intrinsically more efficient than bank deposits and loans in meeting the needs of an increasing number of market segments. This is because putting borrowers and investors together through the vehicle of a security can be accomplished by an intermediary with less equity than a bank would require to serve borrowers using loans and investors providing funds in the form of deposits. Because of this, overall profits necessary to provide an adequate return on the equity employed by the intermediary are less, and therefore spreads are thinner. This gives the borrower a lower cost source of financing and the investor a higher yield source of investment than banks can provide. There are numerous examples of markets

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shifting to this more efficient form. Best known are commercial paper and mortgage-backed securities as alternatives to bank loans and money market accounts as substitutes for deposits. Banks could provide these services themselves, if they were permitted to do so. In fact, because banks arguably have the broadest access to borrowers and investors, they could introduce this more efficient form of financial intermediation to customers who have not yet been able to benefit from it.

3. Third, this transformation of the financial structure of banks would be healthy for customers and for the economy. This is because the market forces creating this change are those of efficiency and innovation. Also, if banks were allowed to respond to these forces naturally, we feel that safety and soundness would be enhanced, not reduced.
4. Fourth, legislation is needed to capture the benefits of this more efficient method of intermediation and enable a smooth transition. Farsighted legislation will be critical to mitigating the risks that could result from banks increasingly being at a legislated competitive disadvantage as these market forces increase. Without deregulation that acknowledges the inefficiencies in the approach that banks are restricted to use today, some banks may increase lending or interest rate risk in an effort to try to obtain acceptable returns on their shareholders' equity.
5. Finally, this period will require many banks to "walk a tightrope" between risk and return while the restructuring is underway. Therefore, we feel that bank supervision should be temporarily bolstered to better define and measure two types of risk: credit risk and asset/liability maturity risk.

The comments to follow flesh out each of these five points.

**I. Banks' Financial Performance Is Now Poor
and Will Continue a Twenty Year Decline
Unless Constraints Are Lifted**

The trend in banks' financial performance suggests that the industry is far from healthy. In fact, by some financial measures, banking is one of the worst performing industries in the United States. Perhaps this is surprising to some laymen and legislators. Historically, banking has been seen as one of the most powerful and prosperous of industries. However, the

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situation is quite the reverse. Of all the industries in America - including the so-called "smoke stack" and "rust bowl" industries - banking is one of the worst off at this time. Exhibit A shows the results of our analysis of data provided by Business Week last year. It shows that the market value of the top 30 banks, divided by their common equity, averaged around 60% in the middle of 1984. This was substantially below that of any other industry, including such notoriously poor performing and mature industries as steel, tire and rubber, and mining. Even with the recent surge in the stock market, the average top 30 bank is trading well below its book value.

What does this mean? Academic literature and empirical research stresses that one of the best leading indicators of future financial condition is a firm's stock price relative to the book equity invested in it. We interpret these findings as strong indication that the markets believe that many larger banks are going to be forced to restructure. That is, either they must fundamentally change their strategy or redeploy their equity. This will be forced on them because corporations with low returns on equity and market-to-book ratios well below 100% cannot internally fund growth and cannot raise equity without compromising the position of existing shareholders.

Why should we be concerned about banks' financial returns to their shareholders? Not because we want to protect these shareholders from risk - they took a risk in making an equity investment and should bear the consequences. It is important for the future efficiency of the financial services industry that the laws of the marketplace be allowed to operate much as they would on any other industry. The problem is that banks' share prices reflect the health of the industry - one which Congress has regulated. I do not believe there is any reason why Congress should wish to indefinitely subsidize banks. But it is important for Congress, if it can, to make the process of transition as least disruptive as possible. For example, there are some 2 million employees in the financial services industry in America. There are at least 100 million small depositors across America whose financial security is tied up with the orderly workings of the banking system. And, of course, the banking industry still plays a crucial role as a financier for America's economy.

While the Committee might have no specific concern for the owners of bank stocks, it is important that it recognize what this poor financial performance implies. Let's say a bank has a market-to-book value of 60%, and reinvests \$100 million in retained earnings. Suppose it does this either to fund its

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growth or to meet new capital adequacy requirements. At a 60% market-to-book, the capital markets transform this \$100 million into stock with an economic value of only \$60 million - thus, \$40 million was destroyed by reinvesting the \$100 million into the bank. The degree of pessimism implied by this outcome, as the capital markets look at banking - and the capital markets are the most efficient forecasters we know - is that they are saying the banking industry is in severe trouble, and is investing capital where on average inadequate returns are being made. An inadequate level of return indicates an industry in decline, producing products and services that are either unwanted or are too expensive relative to competitors' products.

Nor is the traditional banking business encountering a short-term dip in performance. As Exhibit B shows, the top 30 banks have seen a steady erosion in their returns on equity over the past fifteen years, when measured against the returns required by the market. Interestingly, this systematic decline starts about the time that banks ceased leveraging up in the early 1970s, as shown in Exhibit C. That is, once banks could no longer prop up return on equity through higher leverage, as return on assets declined, their average return on equity started to systematically drop.

This poor financial performance is not surprising when one realizes that their traditional formula for financial intermediation is outmoded. Basically, we feel that banks' formula is too "balance sheet intensive," arising from the fact that investors do not invest directly in the credit issued by borrowers, but instead make deposits in the balance sheet of a bank which issues credit.

This approach requires that the bank cover some 5% of the credit with equity, to meet regulatory requirements. This is inherently less efficient than if the credit were directly owned by investors, since spreads have to be wider to provide for a return on the equity invested in the intermediation. Stated another way, the most efficient form of intermediation is one that requires the least equity to perform its function. Equity should only be prevalent when the risk it covers can not be diversified through other, more efficient means.

Thus, when we look at the banking industry, we see all the conditions of an industry that is going into a restructuring phase. This restructuring phase is already upon us in the thrift industry. Here, we feel that deregulation came too late. The thrifts' formula for intermediation was cannibalized by substitute products; they reacted by taking on massive mismatching risk. Now the restructuring of thrifts is occurring with many

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unwanted dislocations. Recently, some people have asserted that the industry as a whole, comprising almost a \$1 trillion of assets, is essentially bankrupt. This happened not because of deregulation, but because the thrifts' traditional formula became less attractive to customers than alternatives offered by competitors.

II. The Winners In the 1990s Will Be Those Institutions That Make Efficient Use of Their Capital

Our view of the banking industry suggests that the same process experienced by the thrifts is underway in commercial banking. There are two major trends which make traditional banking a less competitive business:

1. On the deposits, or liability, side of the banking equation, money market funds, for example, represent a more efficient vehicle for investors. These funds require relatively small amounts of capital to offer savers a market rate of return on what are in effect consumer "deposits". Without a need to charge additional spreads to provide returns on equity that would be required if these were deposits on a bank's balance sheet, these funds are able to offer higher rates of return. The growth of this instrument is only the most publicized alternative to banks' options for investors. For example, last Sunday's The New York Times published a section entitled "Personal Investing". This 72-page guide to personal financial planning contained counsel from various investment advisors, articles on investment alternatives, and advertisements describing the services of various financial institutions. It was interesting to note that of 14 articles on financial instruments, none discussed instruments offered by banks; of 50 advertisements aimed at the investing public, only 4 were for bank instruments; and in the commentary where financial advisers were asked to counsel households of different life stages and financial means, they recommended direct equities, mutual funds, municipal tax-free bonds, real estate, etc. - but in no instance did they recommend depositing money with a bank.
2. On the asset side of the banking equation, borrower's debt that was heretofore financed through bank loans is increasingly being "securitized". For example, commercial loans are being replaced by commercial paper and other forms of securitized debt such as "high yield" or

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"junk" bonds. In consumer financing, mortgages are increasingly securitized. Just as with the money market funds, these instruments require very little capital on the part of the intermediary. Consequently, they can be delivered at lower cost, and of course pose far less risk to the intermediary since the risk of default is accepted and typically diversified by the purchaser of the security. For example, in the period from 1979 to 1984, commercial paper increased 50% faster than commercial and industrial loans. During this same period, consumer deposits in commercial banks decreased by 16% while the money market funds increased by a whopping 317%.

Is this a short-term phenomenon? Are these the only instances that we will see? We feel the answer to both these questions is no. Essentially, an innovative financier that can remove loans from a bank's balance sheet and package them as securities has about 140 basis points - or a 1.4% spread - of cost advantage to play with. That is, by converting the loan to a security, the "financial engineer" eliminates the need for most of the equity and other liquidity assets to support the loan as an asset on a bank's balance sheet. This frees up 140 basis points of cost assuming the bank needed to earn 16% on its shareholders' equity.

Thus, the new game is clear, and the number of financial innovators that are peering into the asset side of banks' balance sheets are many. And why not? They're looking to make a market more efficient and at the same time earn the high rewards that are typically prevalent in the early stages of industry transitions. For example, the rewards earned by Drexel Burnham in "high yield" corporate bonds and Saloman Brothers in mortgage securities illustrates this fact.

Thus, there are now formulas that are already winning out, and they are intrinsically more efficient. Needs are met without requiring as much capital in the intermediation role as banks require. This is why we say that the "bank formula" is becoming increasingly outmoded, since essentially it is too balance sheet intensive, makes inefficient use of equity, and is therefore more costly from a customer's perspective. While regulators claim to see a world where there is not enough capital in the banking system, the truth is in fact that there is a large excess of capital pursuing declining returns.

Will all loans be securitized over time? We feel that the answer here is no. In general, securitization of classes of loans will occur when the risks can be managed more efficiently

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in security form. Financial innovators are continually figuring out new ways to accomplish this. Generically, these ways involve various methods of diversifying risk.

The concept of an industry in decline should be familiar to the Committee. Over the decades, even the greatest industries have declined and been replaced by other more innovative forms of meeting customer needs. This is a fact of life in capitalism which legislators can delay, but not prevent. There is absolutely no reason why the banking industry should not have a life cycle just as the steel industry did, the textile industry did, the tire and rubber industry did, and so forth. The important concept to bear in mind is that if banks are permitted to transition into new forms of intermediation within the broader financial services industry, then the transition will be less severe in terms of customer dislocation. By analogy, imagine if regulation precluded the major U.S. tire companies from evolving to radial tires from bias ply.

We believe that banks can, if allowed, evolve to meet the needs of many investors and borrowers in a more efficient way. They will do this by reducing the size of their balance sheets, dealing increasingly with securitized instruments rather than with deposits and assets. This will create a cost efficiency of approximately 1.4% on assets. This is not insignificant when one remembers that the non-interest expense of a typical bank ranges from 2% to 4% of assets.

Left to their own devices, we feel that successful banks would naturally evolve into these more efficient methods of meeting needs. For example:

- a. Imagine a wholesale-oriented money center bank that increasingly converts its loans into securitized instruments. That is, it sells off many of the loans it originates and, if permitted by deregulation, structures some of the loans it originates into securities backed by pools of corporate debt. One day it announces that it is repurchasing, say, two-thirds of its common equity, dramatically reducing the size of its balance sheet, and emerging as a new form of merchant bank that capitalizes on debt origination, structuring, and placing skills.
- b. Similarly, imagine a consumer-oriented regional bank that over time offers consumers access to investment funds that have liquidity, maturity, and yield characteristics similar to existing types of deposits. Over

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time this bank liquifies the asset side of its balance sheet as well. One day it announces a repurchase of a significant portion of its equity, and transitions to a mutual fund-type structure with a brick and mortar retail distribution system.

These are just two of the transformations we believe are possible. Others that time does not permit us to describe today might be characterized by words such as "operating and information services bank," "retailer," and "loan servicer." We believe this new vision accommodates both large and small banks, wholesale as well as retail.

We believe that this type of transformation will occur within the next 10 years, if Congress allows banks to adapt, and there will be some examples by the late 1980s.

III. The Transformation of the Financial Structure of Banks Is Healthy for Customers and the Economy

When banks have transitioned to one or more of these new roles, we believe the net impact from a public policy perspective will be positive.

As we have described above, efficiency and innovation are the key market forces at work. As balance sheets of banks are reduced in size, equity can be deployed for more productive uses, and the spreads now necessary to intermediate between investor and borrower will decrease.

In addition, safety and soundness will be improved. The level of deposits requiring FDIC insurance will decline. The pressure to take imprudent risks in a vain attempt to try to obtain an acceptable return on equity in the outmoded formula will be reduced.

Some may find it strange that we are projecting a decline in bank deposits by savers. An examination of published data suggests that this decline is already well underway. And, as the role of the "deposit" diminishes, the arguments for distinguishing among the members of the various financial industry subgroups diminish.

The final advantage of the new "formula" will be the way in which risk will be dealt with:

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- ¶ Credit risk will be broadly diversified through the use of securities. It can be even further diversified if mutual funds holding a portfolio of securitized instruments emerge. Further, credit risk can be publicly insured, as entities such as specialist insurers in municipal credit enhancement have demonstrated.
- ¶ Interest rate risk can be stripped out and sold as a separate instrument, or hedged using new forms of financial futures.

Thus, these market forces are in the best interests of most parties concerned. I say most, because if regulation does not provide a way for banks to react to these forces, dislocations could be severe, as has been the case with thrifts.

IV. Legislation Should Allow These Efficiencies to Be Realized and Permit Banks to Adapt

Existing legislation and regulation has defined how banks and nonbanks may compete in meeting the funding needs of business and the investing needs of the public.

Fifty years ago, securities firms offered longer-term, higher-risk alternatives to the investing public, and banks provided short-term, low-risk deposits. The ways in which banks could invest incremental deposits were limited due to concern for the ultimate safety of depositors' funds. In return for low risk, depositors accepted low returns.

Meanwhile, the securities firms have developed instruments to "cherry pick" commercial banks' large, sophisticated depositors and most creditworthy borrowers. As discussed previously, this has been possible because they can mediate between risk characteristics of borrowers and risk appetites of investors more effectively than banks. Securities firms require less equity and therefore need less return. The result benefits both investors and borrowers. Consequently, securitization has picked off many high-quality credits and large depositors, leaving commercial banks to cope with rising funding costs and declining credit quality.

In our view, banks in general cannot continue indefinitely to perform the roles allotted them by legislation without increased risk to their shareholders and ultimately to depositors.

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Capital adequacy exemplifies the problems associated with taking steps to protect the viability of an outmoded formula. Forcing banks to increase their primary capital ratios is in the interest of safety and soundness because capital ostensibly provides a "cushion" to absorb risk. However, since banks are no longer an oligopoly, they cannot pass on the extra cost of increased capitalization to their customers. For example, in the case of a money center bank trying to earn 16% on its equity, if it is capitalized at 6% versus 4% common equity to assets, it needs to charge approximately 60 basis points more on all its loans. Of course, if banks try to raise spreads on existing loans, more market segments will be subject to inroads by nonbanks offering credit via securitization. This could in turn force banks to look for increasingly risky borrowers. And it could also lead banks to take on more interest rate risk than would be prudent.

What else can banks do? They need returns on the equity required by their formula for intermediation. In other words, riskier loans that eat away at the capital cushion more quickly. Consequently, the net effect of increased capital ratios may be a higher - not lower - risk profile for the industry.

If you find these arguments compelling, I think you'll agree that legislation should acknowledge these market pressures in crafting new formulas for banks to compete. Banks need to be able to transition from a balance sheet intensive formula to one that is not inherently disadvantaged. At the same time, legislation must enable banks to build and capitalize on competitive advantage, as this is necessary to provide good returns to shareholders - albeit on a lower base of equity. That is, let them become the best financial engineer, the best technologist, the best marketer, or the best provider of operations and information services.

In pragmatic terms, this suggests further deregulation. This is warranted now because the mainstream businesses of retail and corporate-oriented banks are under attack today.

V. Regulators Should Improve Their Capability to Define and Monitor Risk Through This Challenging Period

Finally, we feel that regulators should improve their approaches to identifying and monitoring risk. By risk, I refer to credit risk and interest rate risk, rather than to capital risk, which, as discussed above, we believe to be a false issue.

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Here, we believe great improvements are being achieved in credit risk assessment. However, in our experience, the process of assessing and pricing loans is far from efficient or at times logical. So there is still room for improvement here.

Also, in the area of interest rate risk, we find the situation quite confused. For example, in our travels, we find that the notions of liquidity risk and repricing risk and how to measure each vary widely from bank to bank. We feel that regulators could provide some thought leadership to help many banks in this area.

Closing Comments

In sum, we believe the forces at work which I have described are not necessarily undesirable, when viewed from the overall perspective of what is good for the economy and for the people. All the changes that I have described create greater efficiency, lead to considerable product innovation, and ultimately result in greater safety and soundness for the industry. The legislative process should support any trend that brings better products and services to the customer at lower cost and makes it easier and cheaper for American industry to finance itself.

In summary, Mr. Chairman and committee members, the thrust of my argument is that the banking industry is in trouble because market forces and innovation are creating better, substitute services.

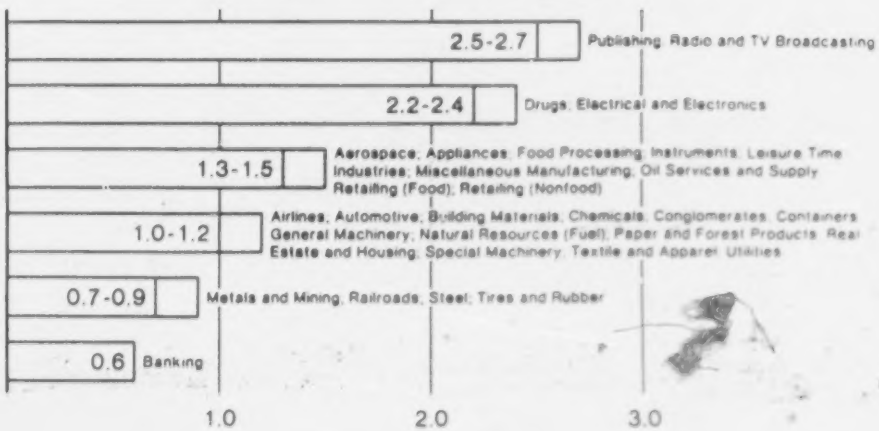
Legislation should not attempt to reverse this. It is unlikely this trend can be altered. Instead, farsighted legislation could enable the best banks and non-banks to craft new financial institutions that will emerge to serve customers and industry more cost-effectively will equal or lower risk.

* * *

I thank you very much for the opportunity to discuss this important subject today.

When compared to other industries, the larger banks currently have sharply lower market-to-book ratios:

INDUSTRY COMPARISONS OF MARKET-TO-BOOK RATIOS



The decline in profitability has been substantial

**RETURN ON EQUITY
DIVIDED BY REQUIRED RETURN**
Average for Top Thirty Banks

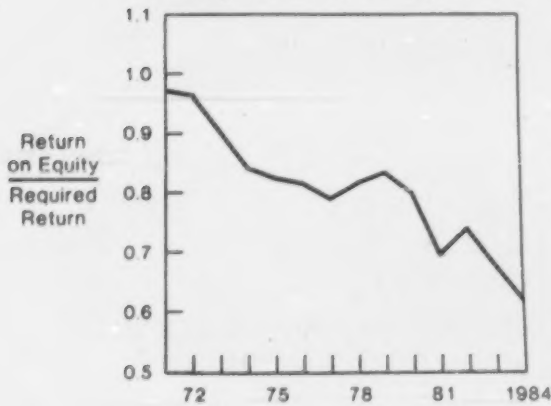
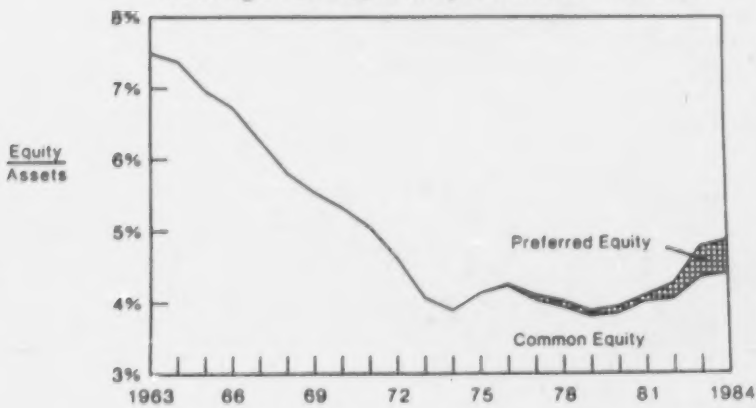


Exhibit C

As ROE declined, growth was financed by year-to-year increases in leverage.
As the regulators crack down on capital ratios, this is no longer viable.

BANK LEVERAGE
Average for Top Thirty Banks: 1963-84



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The CHAIRMAN. Thank you, Mr. McCormick.
Mr. Gunderson.

**STATEMENT OF LEE E. GUNDERSON, PARTNER AND NATIONAL
DIRECTOR OF BANKING INDUSTRY RELATIONS, ARTHUR
YOUNG, NEW YORK, NY**

Mr. GUNDERSON. Mr. Chairman and members of the committee, I am Lee Gunderson, a partner in the national office of Arthur Young located in New York, and national director of banking industry relations for the firm.

Senator Proxmire, I appreciated those kind remarks and just for the record, I still get back to Wisconsin once a month for a board meeting at my bank, so I have not lost touch with that great State.

Senator PROXMIRE. Sounds like you're running for office in Wisconsin.

Mr. GUNDERSON. Never against you, sir.

[The complete prepared statement follows:]

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STATEMENT
OF
LEE E. GUNDERSON

PARTNER
and
NATIONAL DIRECTOR OF BANKING
INDUSTRY RELATIONS

ARTHUR YOUNG
NEW YORK, N.Y.

BEFORE THE
COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

MAY 22, 1985

Mr. Chairman and Members of the Committee:

I am Lee Gunderson, a partner in the National Office of Arthur Young and National Director of Banking Industry Relations for the firm. Arthur Young provides accounting, tax and management consulting services to 44,423 clients in the United States through our 86 offices in this country. Among these are many firms in the financial services industry. Arthur Young also has 284 offices in other countries. I am pleased to appear before this Committee and share my views on the rapid changes taking place in our nation's financial services industry.

In order to assess the changes taking place in the financial services industry, it is important to take a look at where we are today and review some of the history that brought us to this point in time. Over the past five years, partial deregulation of banks has virtually phased out deposit interest ceilings. While this phase-out has helped these institutions compete for deposits, it has not been without its price. Margins, between the cost of funds and the price of these funds to loan customers, has declined. Lack of corresponding deregulation on the asset side of the balance sheet has inhibited the ability of banks to offset the declining margins through the use of new products and services to generate non-interest income. All things considered, the banks have managed this transition quite well through the development of sophisticated asset/liability management techniques, more realistic allocation of costs and pricing to existing products, such as checking accounts, and other fee

income services. This has resulted in higher fees for these products and produced problems for customers having smaller accounts. Cheaper core deposits, previously regulated by interest rate ceilings, had provided a subsidy that was reflected in the fees for these smaller accounts. Deregulation removed that subsidy.

However, in spite of the fact that banks have managed the deregulation of deposits in an effective manner, the challenges for their future still remain. Market share of financial assets continue to decline. The market share of financial assets for banks declined from approximately 39% in 1973 to just under 35% in 1983. During this same time period, the market share of other financial institutions, such as insurance companies and investment companies increased from 38% to approximately 43% (see Table A). Continuation of this trend can only have a negative impact on not only banks, but on the customers that depend on them for loans and services. Return on equity declined from approximately 13% to 11% during the same ten-year period. While overall economic conditions were also a contributing factor, it is obvious that the increased costs of deregulating the liability side of the balance sheet, without an accompanying deregulation of the asset side, had a definite negative impact on earnings. (See Schedule B). These statistics articulate the need for legislative changes to allow banks and thrifts the

opportunity to change not only how they do business, but where they do business, as well. Banks bought some time, during the past five years, through efficient management techniques, but if they are to effectively continue their important role as a financial intermediary for the customers and communities they serve, it is imperative that legislative changes be enacted.

In recent years, a great deal of testimony has been heard by this Committee on expanded powers for banks and thrifts. In 1983, Arthur Young conducted a study for the American Bankers Association evaluating the feasibility of commercial bank entry into 13 financial service areas. The market areas evaluated in the study were:

- o Securities Underwriting
- o Securities Brokerage
- o Mutual Funds
- o Commodities and Futures Brokerage
- o Insurance Underwriting
- o Insurance Brokerage
- o Travel Agency
- o Telecommunications
- o Data Processing
- o Real Estate Brokerage
- o Real Estate Equity
- o Non-full Payment Leasing
- o Management Consulting

The study evaluated each market area, with special attention focused on capital needs, risk potential, skills needed and market potential. It also assessed potential entry of banks into these services as it related to risk exposure, available synergy with the bank's customer base and current product lines. The study also evaluated each of these characteristics for large, medium-size and community banks. A summary of the findings of the study are attached to my testimony.

The market areas that received the highest overall rating were:

- o Real Estate
- o Securities Brokerage and Underwriting
- o Insurance Brokerage

Obviously, in a study evaluating proposed new products for an industry as diverse as banking, there were certain additional market areas that were more attractive to large banks. They were:

- o Mutual Fund Management
- o Insurance Underwriting

It is not my intent to advocate which services and products are appropriate for authorization through legislative action by Congress. However, I hope that this information will contribute to the deliberation process in addressing this critical issue.

Any assessment of the future of the financial services

industry issue and appropriate legislative action must address interstate banking. In my opinion, the question of interstate banking is not whether it will become a reality, but, rather when and how it will become a reality. It is a concept whose time has truly come. In fact, this nation already has a fragmented interstate banking system. A 1983 study by the Federal Reserve Bank of Atlanta showed that, at that time, commercial banks and holding company subsidiaries had 7,840 offices in place throughout the nation.

These include loan production offices, Edge Act offices, consumer finance companies, mortgage companies, credit card companies, trust companies and almost 1550 offices of "grandfathered" interstate bank holding companies. Acquisition of troubled and failed financial institutions, primarily thrifts, has also created limited interstate banking, on an ad hoc basis.

Current geographical limitations do not operate in the public interest. They impair the orderly flow of funds and provide competitive inhibitions in the delivery of financial services to the public. Interstate banking would also facilitate the handling of troubled and failed financial institutions. As an example, we recently witnessed the marathon sessions of the Ohio legislature in responding to the problems created by the failure of a state-insured Ohio thrift. We are seeing a similar problem in Maryland. If interstate banking had been in place in these

two states, the crisis could have been handled in a much more orderly manner. It is apparent that the problems of the thrift industry, in particular, are far from being resolved. Interstate banking would provide access to a much larger base for acquisition of failed institutions. This would not only ease the pressures on the FDIC and FSLIC insurance funds, but it would also serve to maintain the very important element of public confidence in the financial system.

As the members of this Committee are well aware, the interstate banking issue is receiving a great deal of attention. Twenty-one states have enacted legislation allowing some form of interstate banking. Virtually every other state has considered or is considering legislation. Six states have defeated interstate legislation, during their 1985 sessions. It has been a topic of discussion at many meetings of state and national banking associations.

It would be presumptuous of me to attempt to define the appropriate format for interstate legislation in my testimony today. I can only suggest that this issue is critical to the future of the banking system. It is one that warrants the attention of Congress and requires appropriate action. If not, we will continue to see a hodge-podge system created by regulatory fiat, court decisions and end runs around current laws such as we have in the non-bank bank issue. The non-bank

bank issue needs to be resolved in order to provide an orderly and objective evaluation of the much larger issue of interstate banking.

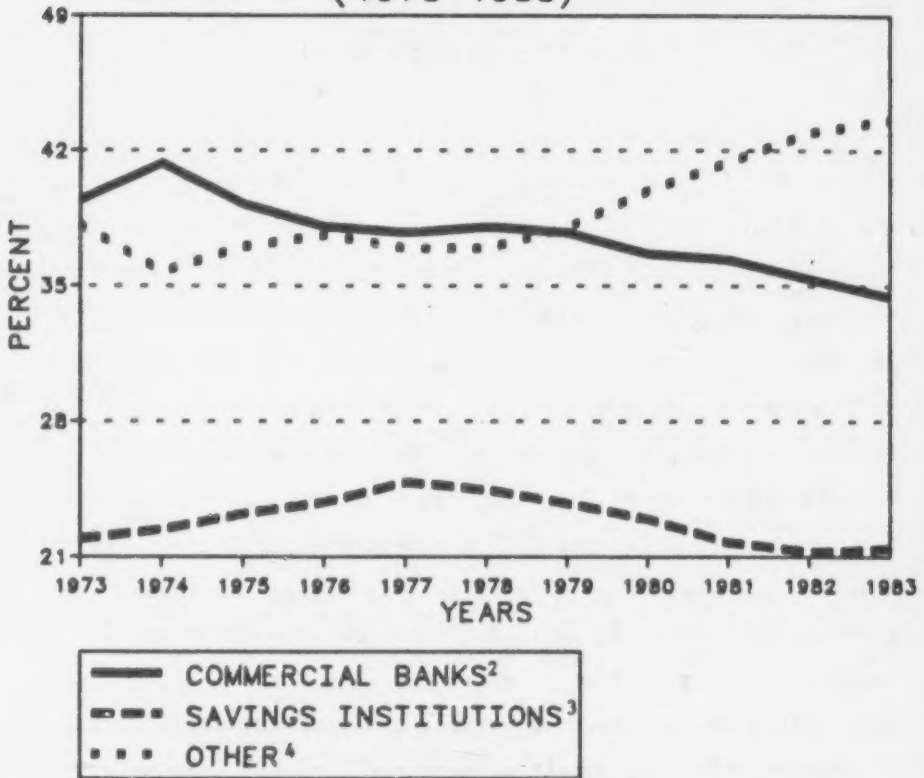
The pervasive element that must be considered in any assessment of the future of the financial services industry is the safety and soundness of the industry. Public confidence is the common thread that holds the industry together. In spite of an increasing number of bank failures and the tremendous amount of media coverage given these failures, confidence in the system remains high. In 1984, there were 79 bank failures. This represents 1/2 of 1% of the total banks in the nation. During the same time period, 455 new banks opened their doors. The banks that failed did so because of a mix of reasons. Poor management was probably the greatest single cause. In other cases, it was a result of deterioration in certain segments of the economy, such as agriculture. My point is that overall, the banking system is sound and bank management has proven its capability to manage their institutions during some challenging times.

Recent proposals by the Treasury and the FDIC requiring banks to increase their capital ratios to 9% would be counter-productive. This action would require banks to raise an additional \$60 billion dollars in non-productive capital. It would also place smaller banks at disadvantage, because of their

limited access to capital markets. While I support the need for a realistic and prudent capital base for banks, decisions regarding the need for additional capital should be made as business decisions by the bank, based upon the requirements of the bank to efficiently serve its customers.

In summary, I feel that there are two essential elements that are critical to the future of banking. The first is a regulatory system that is both responsive to the needs of banking, but at the same time, is a strong regulator. The current system is hampered by the fact that there are simply too few people in the regulatory agencies to meet the needs of today's complex demands. This problem can only be resolved by legislation that will amend current compensation levels in order to attract and retain high-quality individuals. The second element is legislative action by Congress that will respond to the need to provide for the development of a cohesive and efficient financial system. Critical components of this legislation are the inefficiencies of geographical limitations and the need for expanded products and services for banks. Further delay will only result in exacerbating current problems and deficiencies in the system. The end result of continued procrastination will be the continuation of a fragmented banking system, created by end runs around current laws and court decisions. The consumer and the public interest will be the ultimate losers if this is the case.

TABLE A
 SHARES OF TOTAL FINANCIAL ASSETS
 HELD BY FINANCIAL INSTITUTIONS¹
 (1973-1983)



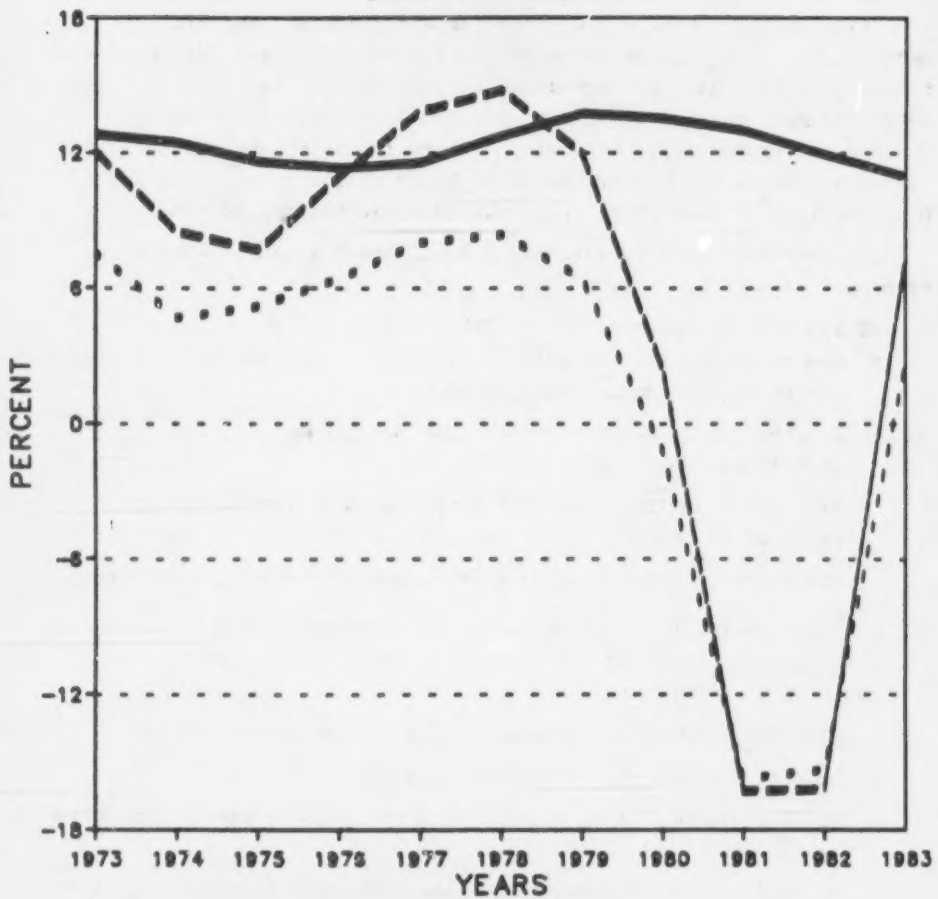
1. INCLUDES CREDIT MARKET DEBT CLAIMS AGAINST NON-FINANCIAL SECTORS, PLUS CURRENCY, DEMAND DEPOSITS, SECURITY DEBT, CORPORATE EQUITIES, MEMBER BANK RESERVES, AND MISCELLANEOUS ASSETS.

2. CONSISTS OF U.S. CHARTERED BANKS, DOMESTIC AFFILIATES, EDGE ACT CORPORATIONS, AGENCIES AND BRANCHES OF FOREIGN BANKS, AND BANKS IN U.S. POSSESSIONS. DOES NOT INCLUDE NON-AFFILIATES OF BANK HOLDING COMPANIES OR FOREIGN AFFILIATES OF U.S. CHARTERED BANKS

3. CONSISTS OF SAVINGS AND LOAN ASSOCIATIONS, SAVINGS BANKS, AND CREDIT UNIONS.

4. CONSISTS OF INSURANCE COMPANIES, PENSION FUNDS, FINANCE COMPANIES, REAL ESTATE INVESTMENT TRUSTS, OPEN-END INVESTMENT COMPANIES, MONEY MARKET FUNDS, AND SECURITY BROKERS AND DEALERS.

SOURCE: FEDERAL RESERVE BOARD FLOW OF FUNDS ACCOUNTS

SCHEDULE BRETURN ON EQUITY AT COMMERCIAL BANKS
AND THRIFTS
(1973-1983)

— COMMERCIAL BANKS
- - - SAVINGS AND LOANS
... MUTUAL SAVINGS BANKS

SOURCES: FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL HOME LOAN BANK BOARD, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Arthur Young conducted a study for the A.B.A. assessing business expansion opportunities for banking within the next decade. The study focused on thirteen basic services. They include real estate brokerage, real estate equity, travel agencies, data processing, telecommunications, management consulting, non full payout leasing, insurance brokerage, insurance underwriting; of course the securities brokerage business both in full service and discount, securities underwriting, mutual fund management and commodities and futures brokerage. This list was developed from input received from an oversight task force made up of representatives from the Community Banking Leaders Council, Economic Advisory Committee and the Corporate Planning Committee. We were asked to focus on the feasibility and profitability of bank entry into each of these service markets.

The methodology used assessed six different areas in evaluating each activity:

1. IS THE LINE OF BUSINESS A GOOD ONE TO BE IN?
 - Has the business been profitable in terms of return on assets, return on equity, or sales margin
 - Has the market grown rapidly? (Presumably faster growing markets would be easier to enter.)
 - Will profitability or growth change in the years ahead in response to technological, demographic or other changes?
 - Are customer relationships generally stable within the market?
2. DO BANKS HAVE ANY RESOURCES OR UNIQUE CHARACTERISTICS OR CAPABILITIES THAT INCREASE THE LIKELIHOOD OF SUCCESSFUL ENTRY INTO THE MARKET IN QUESTION?
 - Does the product or service involve the same customer base?
 - Does it involve similar skills or expertise?
 - Is it closely related to transactions or other services offered by banks?
 - Do other types of financial or non-financial institutions have similar advantages? If so, do they seem poised to enter the market?

- Does the image of banking provide any advantage in offering the product or service? Does offering the product or service affect the bank's image?
 - Can the product or service be offered through the bank's existing locations?
 - Do banks have any locational advantages in the market?
 - Can customer contacts (personal, telephone, mail) be piggy-backed on existing contacts made by the bank?
 - Is the market subject to strong seasonal or cyclical influence? If so, how do these fit into the bank's seasonal or cyclical resource needs?
 - Can the service best be offered through the bank or through the holding company?
3. ARE THERE ENTRY BARRIERS OTHER THAN THE LEGAL PROHIBITIONS AGAINST BANKS OFFERING THE SERVICE?
- How much capital is required for entry?
 - Are there dominant firms within the industry?
 - Is a large volume required to provide the product or service efficiently?
4. ARE THERE ANY CHARACTERISTICS OF THE LINE OF BUSINESS THAT WOULD SEEM TO PROHIBIT BANK ENTRY INTO IT FOR PUBLIC POLICY REASONS?
- Does entry into the market adversely affect the safety and soundness of the bank? If so, can this be offset by segregating the activity in a separate holding company subsidiary?
 - Does entry into the market create any conflict of interest for the bank? Would it help or hurt the bank's ability to offer existing services?
5. WHAT WOULD BE THE EFFECT OF ALLOWING BANKS TO ENTER THE LINE OF BUSINESS?
- How fast would they enter the business?
 - What level of resources will they put into it?
 - How would entry affect prices within the market?

- What will be the effect on bank profitability?
- How will the answers to these questions vary with different scenarios for prospective economic conditions?

6. HOW WILL THE ANSWERS TO THESE QUESTIONS VARY FOR DIFFERENT TYPES OF BANKS?

- Money center banks (assets greater than \$20 billion)
- Regional bank (\$1 to \$20 billion in assets)
- Medium size bank (\$250 million to \$1 billion in assets)
- Community bank (less than \$250 million in assets)
- Unit banking state
- Limited branching state
- State without branching restrictions

The study also analyzed the profitability of each of the thirteen services. Return on Assets, Return on Equity and Profit Margins were reviewed for each market, where the information was available. Some of the more important results were as follows:

Exhibit II
Profitability

	1980 RETURN ON EQUITY	1980 RETURN ON ASSETS	1980 PROFIT MARGIN
EQUIPMENT LEASING ^{1/}	12.5% ^{2/}	1.6%	NA
INSURANCE AGENCY BROKERAGE	39%	5.9%	9.7%
INSURANCE UNDERWRITING	17.2% ^{10/}	NA	NA
PROPERTY CASUALTY	10.17% ^{11/}	NA	NA
HEALTH LIFE			
COMMODITY AND FINANCIAL FUTURES BROKERAGE ^{2/}	NA	NA	NA
DATA PROCESSING ^{3/}			
PROCESSING SERVICES	18.1%	10.9%	13%
SOFTWARE	53%	20.4%	12%
TURNKEY SYSTEMS	15.7.32%	9.6.16.5%	14%
PROFESSIONAL SERVICES	27.3%	8.6%	7%
MANAGEMENT CONSULTING	36.6%	12.6%	7.8%
TAX ADVISORY SERVICES ^{4/}	42.1%	29.6%	14.0%
TRAVEL AGENCY	28.9%	7.6%	4.7%
REAL ESTATE EQUITY ^{5/}	NA	NA	NA
REAL ESTATE BROKERAGE	21.1%	5.2%	14.0%
MUTUAL FUNDS ^{6/}	NA	NA	NA
(INVESTMENT ADVISORY SERVICES)			
SECURITIES BROKERAGE ^{7/}			
CARRYING FIRMS	39%	31%	19.7%
INTRODUCING FIRMS	64%	57%	10.2%
SECURITIES UNDERWRITING ^{8/}	49%	NA	NA
TELECOMMUNICATIONS	NA	NA	NA

NA: NOT AVAILABLE

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THIS EXHIBIT

Another important segment of the study dealt with service market characteristics such as number of firms, recent revenue growth and growth potential, cyclical nature, industry concentration, human capital requirements and critical mass (level of revenues required to provide sufficient return on investment).

Exhibit III

	NUMBER OF FIRMS	RECENT OR PROSPECTIVE GROWTH			ENTRY BARRIERS EASE OF ENTRY				
		1990 \$1 REVENUES	GROWTH POTENTIAL	CYCLICAL	INDUSTRY CONCENTRATION TOP 10	TOP 25	CAPITAL REQUIREMENTS	HUMAN CAPITAL REQUIREMENTS	CRITICAL MASS
EQUIPMENT LEASING	1 NA	NA	MEDIUM	YES	13 NA	NA	HIGH	HIGH	MEDIUM
INSURANCE AGENCY BROKERAGE	8 NA	8 14%	LOW	YES	NA	NA	LOW	LOW	LOW
INSURANCE UNDERWRITING									
PROPERTY/CASUALTY	900	7 4%	LOW	YES	NA	NA	MEDIUM	HIGH	HIGH
LIFE/HEALTH	1 948	11%	LOW	YES	NA	NA	MEDIUM	HIGH	HIGH
COMMODITY AND FIN. FUTURES	400	6 28%	HIGH	NO	98	NA	LOW	HIGH	LOW
DATA PROCESSING									
PRICE/ISSING SERVICES	2 150	9 14%	MEDIUM	NO	23%	49 5%	HIGH	HIGH	MEDIUM
SOFTWARE	1 000 2 000	34%	HIGH	NO	84%	82%	MEDIUM	HIGH	LOW
TURNKEY SYSTEMS	1 800	30%	HIGH	NO	NA	NA	MEDIUM	HIGH	MEDIUM
PROFESSIONAL SERVICES	1 800	25%	HIGH	NO	(12) 42%		LOW	HIGH	LOW
MANAGEMENT CONSULTING	2 500	NA	LOW	YES	(15) 51%	NA	LOW	HIGH	LOW
TAX ADVISORY SERVICES	3 200 000								
TRAVEL AGENCY	300 000	NA	LOW	NO	(1) 10%	NA	LOW	MEDIUM	LOW
REAL ESTATE EQUITY	20 000	10 18%	MEDIUM	YES	NA	NA	LOW	LOW	LOW
REAL ESTATE BROKERAGE	120	NA	LOW	YES	NA	NA	LOW	HIGH	LOW
TELECOMMUNICATIONS	6 650	11 NA	LOW	YES	(11) 20 39%	NA	LOW	LOW	LOW
	500 1 000	18% 30%	HIGH	NO	NA	NA	HIGH	HIGH	HIGH
MUTUAL FUNDS	5 250 750	12 34%	MEDIUM	NO	45 8%	(20) 84%	LOW	HIGH	HIGH
SECURITIES BROKERAGE	9 000	NA	LOW	NO	(8) 20%	81	HIGH	HIGH	MEDIUM
CARRYING FIRMS		NA	LOW	NO	NA	NA	LOW	HIGH	LOW
INTRODUCING FIRMS		NA	LOW	NO	NA	NA	LOW	HIGH	LOW
SECURITIES UNDERWRITING	20	NA	LOW	YES	(8) 41%	88%	HIGH	HIGH	HIGH

NA: NOT AVAILABLE

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THIS EXHIBIT

Consideration of these factors resulted in the following ranking of service market attractiveness:

HIGH

- Securities Brokerage
- Discount Brokerage
- Securities Underwriting
- Real Estate Equity
- Insurance Brokerage
- Data Processing
- Futures Brokerage

MEDIUM

- Real Estate Brokerage
- Management Consulting
- Mutual Funds
- Telecommunications

LOW

- Travel Agency
- Non-Full Payout Leasing
- Insurance Underwriting

A key area of the study assessed bank positioning towards entry into each of the service markets studied. Critical variables in assessing each bank position included:

- Customer base transferability
- Distribution system leverage- does the branch system or correspondent network constitute an advantage?
- Image- is bank image an advantage or would it negatively impact the bank's image?
- Product/Service fit- does the product fit in well with current products?
- Skill fit- can existing bank skills be used or expanded to offer the new service?
- Personnel policies fit
- Defensive motivation- is it important to offer new service to retain customer relationships or to attract new customers?
- Risk- is there significant risk associated with entry into the market, such as financial, customer loss, capital intensity, technological obsolescence, and others.

Exhibit IV
Commercial Bank Positioning For Service Market Entry

	Customer Base Transferability	Overhead System Leverage	Bank Image	Product Synergism	Staff Similarity	Personal Policy Similarity	Risk to a Bank	Corporate Market Entry for Entry
REAL ESTATE BROKERAGE	HIGH	HIGH	HIGH	HIGH	LOW	LOW	LOW	HIGH
REAL ESTATE EQUITY	HIGH	NS	MEDIUM	HIGH	MEDIUM	HIGH	MEDIUM	HIGH
TRAVEL AGENCY	HIGH	HIGH	MEDIUM	LOW	LOW	HIGH	LOW	LOW
BANK PRICES	MEDIUM	NS	MEDIUM-LOW	MEDIUM	MEDIUM-HIGH	HIGH	MEDIUM	LOW
TELECOMMUNICATIONS	HIGH	NS	LOW	MEDIUM	LOW	MEDIUM	MEDIUM	HIGH
MANAGEMENT CONSULTING	MEDIUM	NS	LOW	MEDIUM	MEDIUM	MEDIUM	LOW	LOW
NON FULL PAYOUT LEASING	HIGH	NS	HIGH	HIGH	MEDIUM	HIGH	HIGH	LOW
INSURANCE BROKERAGE	HIGH	HIGH	HIGH	HIGH	LOW	LOW	LOW	HIGH
INSURANCE UNDERWRITING	LOW	NS	LOW	LOW	LOW	MEDIUM	HIGH	LOW
SECURITIES BROKERAGE	HIGH	HIGH	MEDIUM	HIGH	LOW	LOW	LOW	HIGH
SECURITIES UNDERWRITING	MEDIUM	HIGH	LOW	HIGH	LOW	LOW	MEDIUM	HIGH
MUTUAL FUND MANAGEMENT	HIGH	HIGH	HIGH	HIGH	MEDIUM	MEDIUM	LOW	MEDIUM
FUTURES BROKERAGE	HIGH	NS	LOW	HIGH	LOW	LOW	LOW	MEDIUM

NS Not Significant

The analysis of bank positioning also considered the positioning, as it related to large banks (\$20 billion +) regional banks (\$1 to \$20 billion), medium sized banks (\$250 million to \$1 billion) and community banks (less than \$250 million).

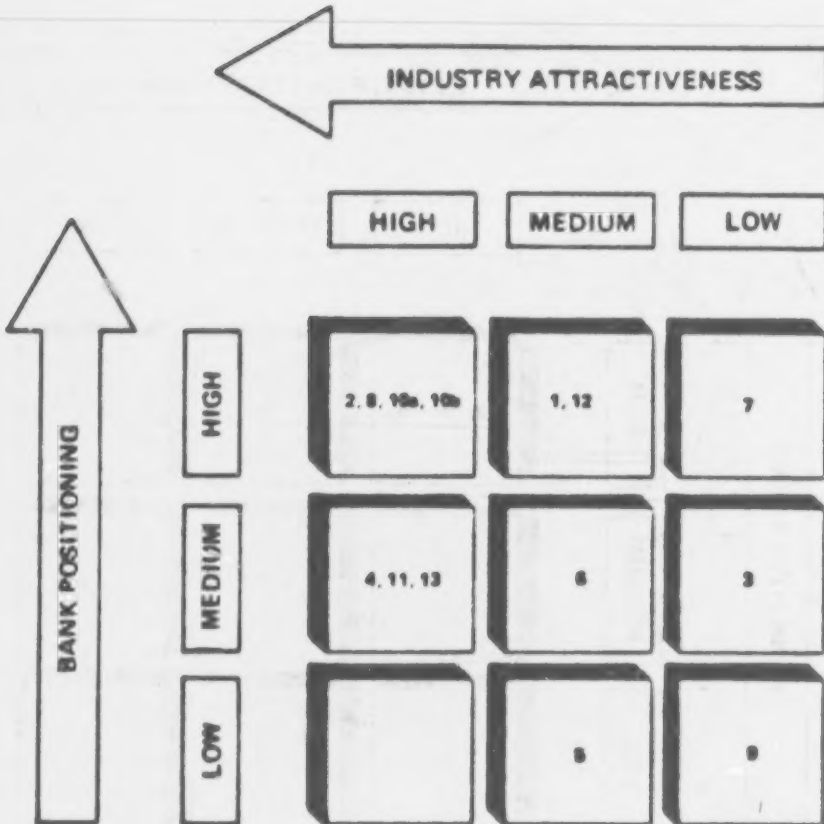
Exhibit IV-A
Bank Positioning

BANK SIZE	HIGH	MEDIUM	LOW
LARGE	Securities Brokerage Credit Brokerage Real Estate Equity Insurance Brokerage Real Estate Brokerage Mutual Funds Non-Full Product Lending	Data Processing Securities Underwriting Future Brokerage Management Consulting Trust Agency	Telecommunications Insurance Underwriting
REGIONAL & MEDIUM SIZE	Securities Brokerage Credit Brokerage Real Estate Equity Insurance Brokerage Real Estate Brokerage	Securities Underwriting Future Brokerage Management Consulting Mutual Funds Trust Agency Non-Full Product Lending	Data Processing Telecommunications Insurance Underwriting
COMMUNITY	Credit Brokerage Real Estate Equity Insurance Brokerage Real Estate Brokerage	Securities Brokerage Securities Underwriting Trust Agency	Data Processing Future Brokerage Telecommunications Management Consulting Mutual Funds Non-Full Product Lending Insurance Underwriting

The results of the industry market attractiveness and the bank positioning analyses were combined to develop a matrix showing the combined results for large, mid-size and community banks. No significant differences were found between medium and regional bank positioning.

Keep in mind, as you view these and as we evaluate each market segment that it is impossible to determine, from a study of this type what may be right for one bank and wrong for another, regardless of size. The study results apply for general banking industry segments and many banks will have unique circumstances that will constitute exceptions to these generalized conclusions. Each bank must reach their own conclusions and make their own decisions. However, I do hope that the information in the study will assist each of you in that important process.

Exhibit V
Bank Positioning Market Attractiveness Matrix
Large Banks

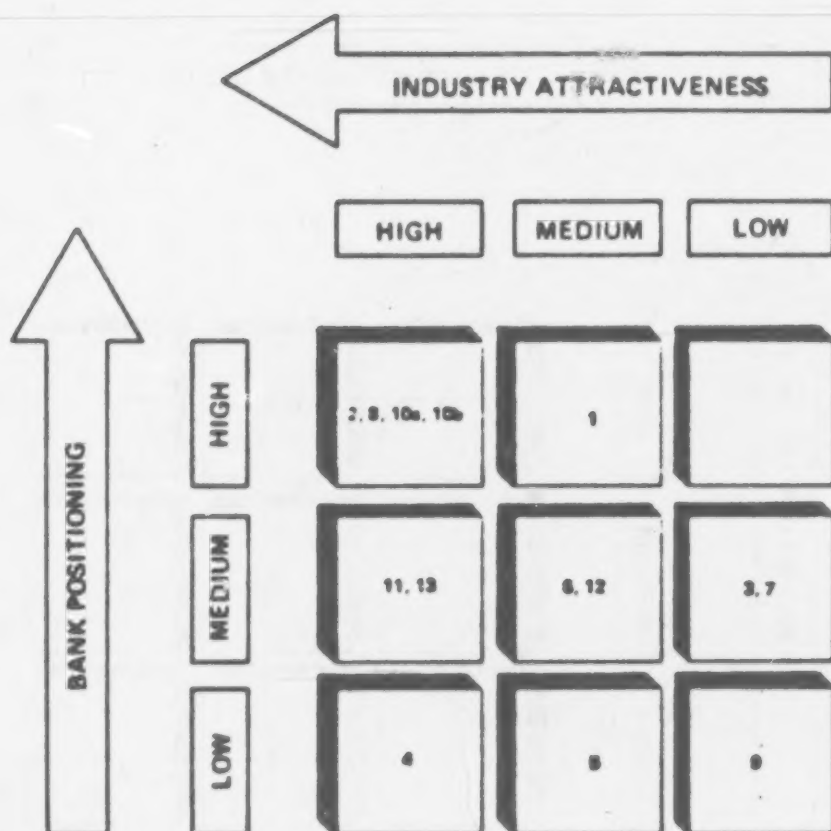


KEY:

- | | |
|----------------------------|--|
| 1. REAL ESTATE BROKERAGE | 9. INSURANCE UNDERWRITING |
| 2. REAL ESTATE EQUITY | 10. SECURITIES BROKERAGE |
| 3. TRAVEL AGENCY | a. DISCOUNT |
| 4. DATA PROCESSING | b. FULL SERVICE |
| 5. TELECOMMUNICATIONS | 11. SECURITIES UNDERWRITING |
| 6. MANAGEMENT CONSULTING | 12. MUTUAL FUND MANAGEMENT |
| 7. NON-FULL PAYOUT LEASING | 13. COMMODITIES/FINANCIAL FUTURES
BROKERAGE |
| 8. INSURANCE BROKERAGE | |

Exhibit VI

**Bank Positioning Market Attractiveness Matrix
Mid-Size Banks**

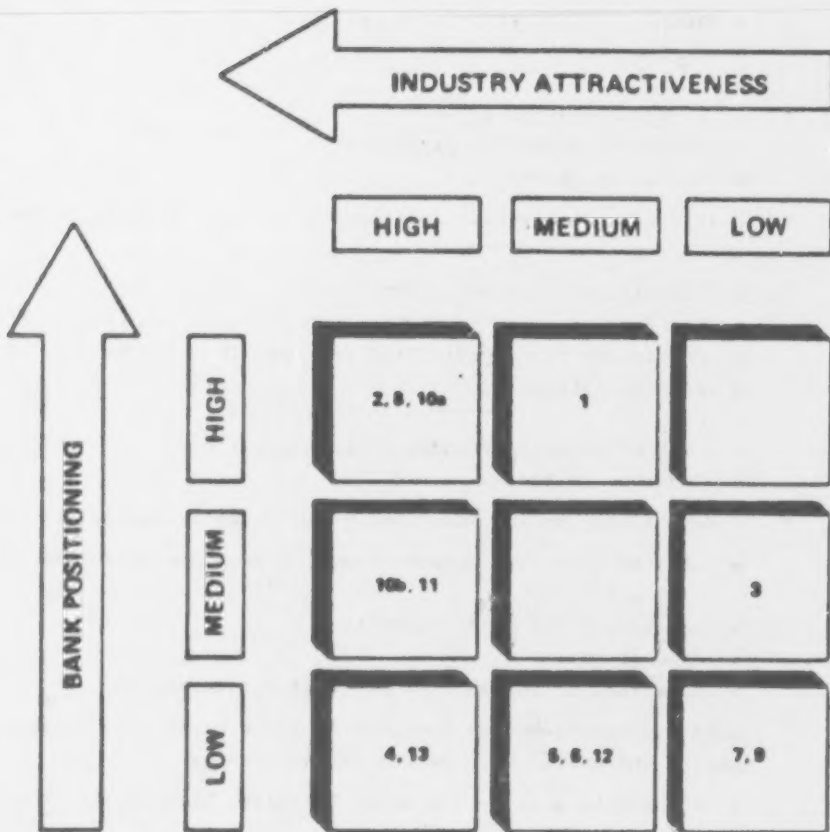


KEY

1. REAL ESTATE BROKERAGE
2. REAL ESTATE EQUITY
3. TRAVEL AGENCY
4. DATA PROCESSING
5. TELECOMMUNICATIONS
6. MANAGEMENT CONSULTING
7. NON-FULL PAYOUT LEASING
8. INSURANCE BROKERAGE

9. INSURANCE UNDERWRITING
10. SECURITIES BROKERAGE
 - a. DISCOUNT
 - b. FULL SERVICE
11. SECURITIES UNDERWRITING
12. MUTUAL FUND MANAGEMENT
13. COMMODITIES/FINANCIAL FUTURES
BROKERAGE

Exhibit VII
Bank Positioning Market Attractiveness Matrix
Small Banks

**KEY**

- | | |
|----------------------------|-----------------------------------|
| 1. REAL ESTATE BROKERAGE | 9. INSURANCE UNDERWRITING |
| 2. REAL ESTATE EQUITY | 10. SECURITIES BROKERAGE |
| 3. TRAVEL AGENCY | a. DISCOUNT |
| 4. DATA PROCESSING | b. FULL SERVICE |
| 5. TELECOMMUNICATIONS | 11. SECURITIES UNDERWRITING |
| 6. MANAGEMENT CONSULTING | 12. MUTUAL FUND MANAGEMENT |
| 7. NON-FULL PAYOUT LEASING | 13. COMMODITIES/FINANCIAL FUTURES |
| 8. INSURANCE BROKERAGE | BROKERAGE |

Let's take a look at each of the services, as they relate to position and market attractiveness and also to the size of bank:

1. Real Estate Brokerage-High Positioning and Medium Attractiveness, all sizes.
 - Low capital needs
 - Low skill intensity
 - Strong linkage with other services
 - Little risk in market
 - Image is an asset
 - Highly competitive
 - Integrate different pay scale
 - Declining demand
2. Real Estate Equity-High Positioning and High Attractiveness, all sizes.
 - Capitalize on existing expertise
 - Benefits of property income, appreciation and tax benefits
 - Fee income from syndicating real estate ventures
 - Capital intensive
 - Cyclical
 - Risk of default or under performance
 - Requires skills
3. Travel Agency-Medium Positioning Low Attractiveness, all sizes.
 - Limited synergism between travel agency products and bank services
 - Relatively low profit margins
 - Special skills
 - Potential of revision of protective regulations
4. Data Processing-Medium Positioning large banks; Low Positioning medium and small, High Market Attractiveness
 - Attractive market- low entry barriers, high growth, non cyclical nature
 - Medium to high capital needs
 - High skill intensity
 - High obsolescence risk

4. (continued)

- Larger banks are better positioned
- Low ROA
- Software and professional service segments offer higher profit potential and less capital requirements

5. Telecommunications- Low Positioning Medium Attractiveness, all banks

- Large capital needs
- Skill intensive
- Large competitors AT&T, GE, GTE
- Videotex- some larger banks
- Electronic Mail

6. Management Consulting- Medium Positioning large and medium, low for small banks; Medium attractiveness

- Cyclical
- Highly concentrated
- High skills
- Low growth
- Some product synergism-financial counseling, tax advisory
- Larger banks market special skills

7. Non Full Payout Leasing- High Positioning large banks, Medium for mid-size and low for small banks
Low Attractiveness

- High profits
- Capital intensive
- Credit, capital and residual risks are extensive
- Large banks are well positioned- capital, experience and access to capital intensive industries
- Regional positioning similar to large banks
- Limited opportunity for small banks

8. Insurance Brokerage- High Attractiveness and High Positioning all banks

9. Insurance Underwriting - Low Attractiveness and Low Positioning for all banks
 - High risk
 - Skill intensive
 - Cyclical
 - Non-growth market
 - High capital
 - No product synergism
- 10a. Discount Securities Brokerage High Attractiveness and High Positioning for all banks
 - Have customer base
 - National product link
 - Limited skills
 - Defensive maneuver
 - Small banks can provide through correspondent or service bureau
 - Growing market-recent survey by Market Facts
 - 10% of retail trades 1982
 - 18% " " " 1983
 - 40% by 1986 - 1987
- b. Full Service Brokerage-High Attractiveness and High Positioning for Large and Medium Banks- Medium Positioning Small Banks
 - Attractive market
 - High profitability
 - Low capital
 - Low risk
 - Extensive customer base
 - Strong distribution system
 - Image
 - Synergy of products
 - Special skills - problem for smaller banks
11. Securities Underwriting- High Attractiveness - Medium Positioning
 - High entry barriers
 - Highly profitable
 - High concentration

11. (continued)

- High capital
- Skill intensity
- Cyclical
- Large banks best positioned- acquire expertise, buy into distribution system and amass needed capital. Customer base
- Regional banks could pursue regional market- acquire regional firm
- Small banks- limited opportunities. May be able to underwrite some local municipal issues

12. Mutual Fund Management-Medium Attractiveness - High Position large banks, Medium mid size and Low Position small banks

- Highly profitable
- Non-cyclical
- High skill intensity
- High critical mass requirement
- Large banks and some mid-size have capability
- Small banks could through consortiums or correspondent

13. Commodities/Financial Futures

Brokerage - High Attractiveness;

Medium Positioning Large and Mid-size banks; Low Positioning small banks.

- Very attractive market
- Fastest growing of Futures brokerage
- Low capital intensity
- Low critical mass
- High skill requirements
- Large banks best suited customer base. Experience in hedging Product synergism
- Need the expertise
 - Personnel policies
 - Incentive compensation

The CHAIRMAN. Thank you, Lee.
Mr. Friedman.

STATEMENT OF JOEL P. FRIEDMAN, ARTHUR ANDERSEN & CO.

Mr. FRIEDMAN. Good morning, Mr. Chairman and members of the committee. My name is Joel Friedman and I am a partner in the San Francisco office of Arthur Andersen & Co., specializing in financial services industries.

I am pleased to have the opportunity to share the findings of several comprehensive studies on the financial services industry trends.

Mr. Chairman, with your permission, I wish to submit my written statement for the record.

The CHAIRMAN. It will be included.

DELPHI STUDIES

Mr. FRIEDMAN. First, some brief background on our studies. For the past 6 years we have published a series of Delphi forecasts in a variety of industries; they focus on major trends and strategic directions of industry participants and competitors.

My testimony today is based on four of our studies: life insurance, securities, and two banking studies—one published in 1983 and second completed last month.

These studies present an insider's view of how industry decision-makers see their markets, themselves, and their competitors. Although these studies were fairly comprehensive, my testimony will focus primarily on consumer markets where much of the competitive battle will be waged.

CHANGING ROLES OF FINANCIAL SERVICES PROVIDERS

In reviewing our findings, let me begin by discussing the nature of change in financial services and the forces that compel it.

For most of the past 50 years, the roles of financial services providers were clearly delineated. One went to a bank for transactional convenience. Securities firms provided opportunities to create wealth. Life insurers offered protection.

Today, things have changed. Products have proliferated, and provider roles have changed accordingly. One can buy stocks through Bank of America, obtain mortgages from General Motors, receive credit cards from Sears, and use electronic banking services at Safeway, Kroger, and Exxon.

These and other changes in banking, securities, and life insurance appear to share a number of common characteristics.

In the life insurance business, economics and increasing consumer sophistication have been the most prominent causes of change. Traditionally, life insurance products offered protection with some degree of enforced savings. Double-digit inflation, however, made whole life insurance far less competitive. This compelled substantial product innovation, including universal and variable life policies that are less profitable to underwriters.

In light of declining profits and new competition from diverse financial service providers, life insurers are adopting a three-

pronged strategy: Offering new products, cutting distribution costs, and paring operating costs.

Looking next at the securities industry, the respondents ranked the most significant factors causing change, including: Competition from nonsecurities firms; competition among securities firms; customer preferences; and economic factors.

Together, these have stimulated a number of changes. To a great extent, institutional investors now dominate the securities markets, transforming the industry's economic structure. Commissions are now far less important; accounting for 55 percent of 1973 revenues, but only 24 percent of projected 1988 revenues.

Securities firms also face new competition from both banks and insurance companies; 81 percent of the securities executives expect major bank entry into their business, and over half foresee insurance companies as major competitors.

Like life insurers, securities firms want to broaden their product lines and use their distribution capabilities more efficiently.

The banking industry is responding to a number of forces. Ten years ago, consumers selected banks for convenience as much as anything else. Today, consumers can make meaningful choices among institutions, and banks are scrambling to find new ways to distinguish themselves from their rivals.

Deregulation of deposits and increasing competitive pressure on loan pricing have severely squeezed bank margins. From 1979 to 1983, the industry average return on assets declined almost 16 percent. Return on equity fell roughly 20 percent. Consequently, banks find a tremendous need to diversify their earnings—by introducing new products and by increasing noninterest income. The largest banks projected that, by 1990, fees will produce up to 43 percent of their net income.

Another pressure is the invasion of nonbank competitors. During the next 5 years, bankers expect to face insurance company competition in home mortgages, mutual funds, commercial lending, and financial counseling. They anticipate that securities firms will offer transaction accounts, financial counseling, asset management accounts, and the like.

Changing customer needs have also affected all three industries. Customer loyalty was once taken for granted; today, prior relationship has declined as a customer purchase criterion. More important now are pricing and the perceived safety of the institution. Diminished loyalty has forced all institutions to become far more aggressive in competing for new relationships and solidifying old ones.

INDUSTRY TRENDS AND STRATEGIES

How are securities firms, life insurers, and bankers responding to these forces? Their directions are fairly similar. Four trends help to demonstrate this point; greater industry consolidation; expanded product offerings; greater market segmentation; and changing distribution channels.

The wave of securities firm mergers that followed May Day in 1975 is a good point to begin a discussion of consolidation. Many famous names have since disappeared or become appendages to other names. Securities executives expect this consolidation to con-

tinue. By 1988, the respondents project that 10 firms will hold almost two-thirds of the industry market share, and 25 firms will have captured over 80 percent.

Life insurance trends are similar. Between 1982 and 1990, small firms will lose 28 percent of their market share. Large companies will experience a corresponding increase of 20 percent.

The potential for consolidation is most pronounced in banking. In our 1983 study, bankers predicted that by 1990 the number of banks would fall by about 36 percent to roughly 9,600. Our more recent study, which polled only large institutions, projects only a 22 percent decline.

Let's look next at product offerings. Securities executives expect a number of nontraditional products to become standard—including transaction accounts, personal insurance, savings accounts, and automated banking.

The insurance companies are more introspective, focusing first on investment-based insurance products of shorter life spans and smaller profit margins. They also plan to diversify into other products including: Asset management accounts, mutual funds, financial planning, home mortgages, commercial loans, and securities brokerage.

In banking, two areas seem to offer the most promise. First, banks plan to expand consumer financial services—both deposit and lending. The second area capturing bankers' attention is securities brokerage. The majority of banks plan to enter this business, and anticipate a 21-percent market share by 1990.

Banks will also offer other products, including investment banking, mutual funds, and financial planning. Over half the banks expect to offer both property and casualty as well as life insurance by 1990.

The third important trend is market segmentation. As product choices expand and customers learn more about financial alternatives, providers need to tailor market strategies to the needs of specific customer segments, much like the airlines creating different programs and fare structures for business versus vacation travelers.

Segmentation strategies depend greatly on the existing industry profile. The securities industry has traditionally focused on the affluent and will continue to focus on households with incomes in excess of \$80,000 per year. They also will target middle market corporations and institutional money managers.

The life insurance business has traditionally segmented broadly across all markets, tailoring products to specific customer groups. Insurers plan to continue in this direction, but they too will begin to concentrate more on affluent consumers, particularly by adding investment options to insurance policies.

Banking segmentation strategies will differ by size of bank. Generally, large banks plan to pursue a broad national market with different strategies for different segments. Midsized banks also suggested a fairly broad but more regional scope, concentrating on the same targets as the large banks—particularly the up-scale retail and corporate middle markets. Most small banks plan to retain their traditional narrow geographic scope, serving most customers in the same fashion.

Having developed product and segmentation strategies, managers must next decide how best to distribute their product to the target markets. All three industries are saddled with distribution channels designed for less complex times.

Securities firms have a significant strategic investment in their account executives. They hesitate to take any action that would compromise the important relationship between the account executive and the retail customer.

Looking forward, the account executive will remain the primary distribution channel. However, the role will change to that of a financial adviser, assisted by salaried personnel with specialized expertise.

Securities firms will also expand distribution channels to direct mail, personal computers, and joint ventures with other financial services providers, such as banks and insurance companies, forming alliances without having to resort to merger.

Life insurance companies have traditionally depended on captive and independent agents. At the end of the decade, these will each account for only 28 percent of total premiums. Other sources will become increasingly significant, with over a third of premiums coming through securities brokerage firms, banks, direct mail, and retailers. In this environment, life insurers will increasingly become manufacturers of their products, looking elsewhere for distribution and retailing.

Banks face a different kind of distribution dilemma. Today, they are saddled with expensive and antiquated branches, many of which are ill-suited for broadened product lines.

As a result, banks plan to follow a number of distribution strategies. Unprofitable branches will be closed or reconfigured for greater self-service banking. Direct mail will be used to sell and service products such as credit cards and equity loans. Joint ventures with other financial service providers will include arrangements with insurance and securities firms to distribute their products in the bank branch. They will also include relationships with other banks to support technology-based delivery.

Before I close, let me add a few words on one of the consistent ideas resulting from these industry changes—the concept of one-stop financial shopping—the financial supermarket. The studies suggest that the supermarket is more myth than reality.

On one hand, diversified financial service providers have already emerged. My bank, for example, offers a variety of deposit services, loans, transaction cards, home banking, discount brokerage, municipal bonds, financial planning, and insurance. American Express offers me travel-related financial services, securities, and insurance. Sears offers brokerage, real estate, securities, banking, credit cards, and insurance.

On the other hand, our survey respondents cite several reasons for thinking that a totally diversified strategy is difficult to execute: First, most providers lack management expertise in all business lines; second, most would have to reformulate their compensation policies to attract and retain key staff; third, finding adequate capital would be difficult; and finally, varied customer desires are difficult to serve comprehensively.

In a recent McGraw-Hill research survey of 2,000 Business Week subscribers, only 32 percent preferred to obtain their financial services from a single institution. As customers grow more sophisticated, they are increasingly willing to shop around for the institution best suited to their current specific need.

As a result, most of the institutions responding to our surveys reported no plans to become financial supermarkets. In fact, many plan to specialize in order to capitalize on existing or potential strengths. We have seen, for example, Bankers Trust sell off its retail branches to become a wholesale banking institution. Wells Fargo Bank will substantially shrink its international banking business to focus on the California retail and middle market segments.

CONCLUSION

In conclusion, market forces are creating both the need and opportunity for financial services providers to change traditional roles. In fact, to survive, change is almost mandatory. Will Rogers observed that "even if you're on the right track, you'll get run over if you just sit there."

Failure to change in this industry is likely to lead to stagnation and decline.

As institutions redefine their competitive positions, our regulatory system must continue to protect the public interest. I hope this testimony will assist you in establishing a legal and regulatory structure to deal with the financial marketplace of the future.

[The complete prepared statement follows:]

PREPARED STATEMENT
OF
JOEL P. FRIEDMAN
Arthur Andersen & Co.

Mr. Chairman and Members of the Committee.

My name is Joel Friedman, and I am a partner in the San Francisco office of Arthur Andersen & Co. Most of my time is spent working with clients in financial services industries. Although I concentrate on banking, I have also worked with a number of clients in the securities and insurance industries. I am a member of our firm's banking industry team, which coordinates our industry activities. In 1983, I was co-author of New Dimensions in Banking: Managing the Strategic Position, a forecast of key trends in the banking industry. The study was developed in association with Bank Administration Institute.

Our firm, founded in 1913, serves more than 90,000 clients through 176 offices, 72 of these in the United States. Arthur Andersen & Co. is made up of more than 28,000 people, of whom 1,681 are partners and about 20,000 are managers and professional staff.

I am pleased to have the opportunity to share our findings on trends in the financial services industry. We commend your decision to hold hearings on this important subject and hope that the Delphi study results I will report today prove useful in your deliberations.

My testimony is divided into three parts. The first describes the Delphi study technique and our procedures. The second and third address the studies' findings: the changing roles of financial service providers, and strategies these providers are using to adapt successfully to their new environment.

Delphi Studies

For the past six years, we have published a series of Delphi forecasts in a variety of industries, focusing on major trends and the strategic direction of industry participants and competitors. Delphi studies elicit and examine the opinions of many individuals who influence a given industry and then assemble these opinions in an organized way to highlight probable future developments. Survey teams ask participants about topics such as future business conditions, market trends and competitive behavior. Corporate decision-makers find these studies an effective planning tool in developing their organizations' own strategies. The Delphi forecasting technique was designed to achieve consensus among a diverse group of experts. It has several key elements:

- o Panels of experts. These studies solicit the views of a broad group of industry experts including industry executives, competitors, regulators and legislators. This forum for comparing opinions establishes a better foundation for planning.
- o Anonymous surveys. To avoid the "noise" often associated with group interaction, survey teams use anonymous mail questionnaires, encouraging candid and unbiased response.
- o Iterative feedback. Unlike typical surveys, the Delphi technique relies on multiple rounds of questioning to narrow the range of responses and develop consensus opinions. Controlled statistical and commentary

feedback to respondents allows them to revise their original forecasts based on new evidence submitted by other panelists.

As a result, this technique allows the survey team to reflect consensus opinions of industry leaders and decision-makers (as opposed to the subjective opinions of consultants) about future industry direction.

Does this technique produce accurate forecasts? Generally, yes -- tracking Delphi forecasts over time demonstrates a reasonably high degree of accuracy about general industry direction. More interesting and important -- the optimum moment for making most decisions does not await the arrival of complete information: Absolutely accurate forecasts are beside the point. Right or wrong, organizations make strategy and investment decisions based on their assumptions about the future, competition and customer needs. If the assumptions prove false, strategies gradually change as firms realize their errors. Thus, these forecasts strongly indicate where the industry is headed, regardless of whether specific survey answers were on the mark. This should be kept in mind as I present our findings today.

My testimony today is based on four of our completed studies:

- o Banking: Published in conjunction with Bank Administration Institute in 1983, the survey reflects responses from over 280 participants. The panel of experts included the chief executive officers (CEOs) of banks and major nonbank financial competitors, bank operations officers, regulators, legislators and financial analysts specializing in the banking industry.

- o Life Insurance: The insurance study, performed in 1984, was co-sponsored by the Life Office Management Association. More than 150 industry executives responded to the questionnaire. The four panels were made up of the CEOs of large and mid-sized insurance companies (with over \$5 billion of insurance in force), the CEOs of small life insurers, future corporate leaders and technology executives.

- o Securities: The securities Delphi, published in conjunction with the Securities Industry Association in 1985, queried over 600 respondents. Panels included CEOs and senior managers of securities firms, nonsecurities financial competitors, regulators and legislators, industry observers, commercial user institutions such as pension funds and banks, and corporate financial officers. A telephone survey of 300 retail customers supplemented our research.

- o Banking: This 1985 study, focused on large banks, was performed for the Association of Reserve City Banks, a membership organization including the largest banks in the United States. Over 80% of the ARCB's 151 members responded to the survey, which treated from the perspective of large banks the same issues as the earlier banking Delphi study. This study also included two telephone surveys: one of 100 consumers with household incomes in excess of \$35,000, the other of chief financial officers of companies with sales between \$50 - \$100 million.

These studies present an insider's view of how industry decision-makers see their markets, themselves and their competitors, and how these perceptions relate to the needs of potential customers.

Changing Roles of Financial Services Providers

For most of the past 50 years, the roles of financial services providers were clearly delineated. Customers could choose from a relatively limited menu of products that were usually standardized within a given industry. Customers knew exactly what kind of firm provided which products. One went to a bank for deposits, loans and transactional convenience. Securities firms offered opportunities to create wealth. Life insurers provided protection with some degree of forced savings. Prices were fairly constant, when not regulated. As a result, customers often heavily based their purchase decisions on loyalty and prior relationship.

Today, things have changed. Products have proliferated during the past few years, and provider roles have changed accordingly. Today, one can buy stocks through Bank of America, obtain mortgages from General Motors, receive general purpose credit cards from Sears, and use electronic banking services at Safeway, Kroger and Exxon. In financial circles, everyone is eager to discuss the so-called "financial supermarket," where consumers can engage in one-stop shopping for all financial needs.

Our Delphi studies on the banking, securities and life insurance industries help pinpoint the forces behind these changes. They also assess expectations of competitive behavior and probable strategic responses from industry leaders. Although the studies were fairly comprehensive, my testimony will focus primarily on consumer markets, where much of the competitive battle will be waged.

The Forces Driving Change

No single set of factors determines change in every financial services industry. Nevertheless, changes in banking, securities and life insurance appear to share common characteristics. These include regulatory change, economic conditions, resulting profit pressure, competition, technology and, of course, customer behavior and sophistication. I would like to discuss briefly how each of these factors affects the three industries.

Life Insurance

One typically thinks of deregulation as the primary motivator of change in many of these industries. Deregulation has not, however, been a significant issue for life insurance companies -- insurance is generally regulated by states, not the Federal government. Insofar as regulation is an issue, insurers worry as much about banking deregulation and banks entering the insurance business as they do about their own regulatory environment.

The economy and increasing consumer financial sophistication have been the most prominent causes of change in the life insurance business. Traditionally, life insurance products offered protection with some degree of enforced savings. This worked well during periods of low inflation, when the low interest rates on whole life insurance policies were generally in line with returns from other investments. Double-digit inflation, however, made whole life insurance far less competitive, making customers less eager to purchase this traditionally profitable product. This environment compelled

considerable product innovation. Insurers moved to universal and variable life insurance policies that respond better to market needs, though they are less profitable to underwriters.

As profits decline, insurers find a need for increased sales volume and improved control of distribution costs to better utilize the existing agent network. Encroachment by banks, securities firms and other diversified financial providers adds another worry. In this environment, life insurers appear to be adopting a three-pronged strategy: offering new products (particularly with enhanced investment features), cutting distribution costs and, at the same time, paring operating costs.

Securities

In the securities industry, deregulation effectively began ten years ago when commissions were deregulated. Many effects of deregulation have already been realized; this is no longer a compelling issue. Respondents to the Delphi survey ranked the factors they find most significant in creating change. In the retail securities business, these include:

- o Competition from nonsecurities firms
- o Competition among securities firms
- o Customer preferences
- o Economic factors

On the institutional side, respondents identified the same factors but in a different order. Competition among securities firms ranked most important, followed by customer preferences and competition from nonsecurities firms.

Together these factors stimulated a number of changes in the securities business. To a great extent, the market has become institutionalized. Individual ownership of stock is more frequently indirect, through pension funds and other sources. Institutional investors have grown far more sophisticated, demanding substantial product innovation and creativity.

As a result, the industry's economic structure has been transformed. Commissions are now far less important. In 1973, commissions accounted for 55% of total revenues. By 1983, the figure was 28%, and the panelists projected that by 1988 commissions will account for only 24% of total revenues. On the other hand, profits from investment and trading activities have increased from 9% of total revenues in 1973 to 26% in 1983 and will reach a projected 29% by 1988.

Securities firms face, along with structural change, new competition from both banks and insurance companies. Our studies showed that 81% of securities executives expect major bank entry into the securities business, and 53% foresee insurance companies as major competitors as well (Exhibit 1). Executives of large life insurance companies responding to our survey agree that they are likely to enter the securities brokerage business, but they predict only limited success. The securities executives expect this entry both through acquisitions of securities firms and through de novo

start-ups. They believe that banks are likely to acquire both discounters and national full-line firms, while insurance companies will probably target the national full-line securities firms.

Like life insurance companies, securities firms are focusing on broadening their product lines and using their distribution capabilities to cut costs.

Banking

Deregulation, economic changes, competition from nonbank institutions and pressure for greater profits are driving change in the banking industry. Regulatory changes since 1980 have substantially altered many old ground rules. Products, prices and market boundaries are no longer as fully defined by regulation. Ten years ago, most consumers found it difficult to distinguish one bank from another; they chose banks as much for convenience as for any other reason. Today, consumers can make meaningful choices among institutions, and banks are scrambling to find new means of distinguishing themselves from their competitors.

Deregulation of interest on deposits and increasing competitive pressure on loan pricing have severely squeezed bank margins. According to Federal Reserve data, from 1979 to 1983, the industry's average return on assets declined from 0.76% to 0.64%. Return on equity fell from 13.2% to 10.7%, roughly 20%. Noninterest expense as a percent of total assets rose by 20%, from 0.24% to 0.29%. At the same time, regulators have raised capital requirements to preserve the soundness and stability of the industry, which

reduces banks' leverage and potential earning power. Consequently, banks have found a significant need to diversify their earnings stream. They have accomplished this in two ways -- first, by introducing new products and, second, by increasing fee or noninterest income. The largest banks responding to the ARCB study projected that, by 1990, fees will produce up to 43% of their net income. The need for cost control goes hand-in-hand with enhancing the revenue stream, and banks have aggressively sought ways to reduce the cost of doing business.

Another pressure comes from the invasion of nonbank competitors, which opens an institution's customer base to considerable competitive attack. Over the next five years, the bankers surveyed expect to find insurance companies competing in offering home mortgages, mutual funds, commercial lending and financial counseling. They anticipate that securities firms will offer transaction accounts, financial counseling, asset management accounts, and the like. (Exhibit 2).

Customer Perceptions

Changing customer needs and perceptions have also affected all three industries. Customer loyalty was once taken for granted; today, prior relationship has declined in rank as a customer purchase criterion in both the insurance and banking industries, as well as on the institutional and corporate side of the securities business. More important now are pricing (which was heretofore regulated in many cases) and the perceived safety of the institution. Diminished loyalty has forced all institutions to become

far more aggressive in competing for new relationships, as well as solidifying old ones.

In summary, for somewhat different reasons, all three industries -- banking, securities and life insurance -- have ended up with relatively common needs:

- o Broader product lines, both within and outside existing industry and geographic boundaries
- o Expanded distribution capabilities and lower distribution costs
- o Improved customer relationships
- o Better cost control

Industry Trends and Strategies

Although the forces of change differ somewhat in each industry, the resulting direction of the banking, securities and life insurance industries is fairly similar. This should not be surprising -- it reflects the fact that these industries are increasingly interdependent. Actions taken by one can affect the other two.

A brief discussion of the following trends helps demonstrate these similarities:

- o Greater industry consolidation
- o Expanded product offerings
- o Greater market segmentation
- o Changing distribution channels

Also worth noting is another often remarked development -- the emergence of financial supermarkets.

Consolidation

A wave of securities firm mergers followed May Day in 1975; many famous names have since disappeared or become appendages to other names. Securities executives expect this consolidation to continue (Exhibit 3). In 1983, for example, the top 10 firms accounted for 54% of total industry revenues. Our respondents expect this figure to reach 61% by 1988. The next 15 firms, which had 20% market share in 1983, will hold relatively stable at 21% in 1988. The remainder of the industry, which had 26% market share in 1983, will decline to 18% by 1988. If these predictions are accurate, 10 firms will hold almost two-thirds of the industry market share, and 25 firms will have captured over 80%.

Life insurance trends are similar. Insurance executives expect that merger and acquisition activity will grow more intense as life insurance

companies pursue new markets and new distribution systems. The study predicts that, between 1982 and 1990, small firms (with less than \$5 billion of insurance in force) will decrease in number by 41%, from 875 to 515, with a 28% decline in market share, from 18% to 13%. The number of large companies (with over \$50 billion of insurance in force), on the other hand, will increase by 35% with a corresponding market share increase of 20%, from 40% to 48% (Exhibit 4).

The potential for consolidation is perhaps most pronounced in banking. In our 1983 banking Delphi study, bank chief executive officers predicted that the total number of banks in the U.S. would fall from roughly 15,000 in 1980 to 9,600 by 1990, a decline of 36% (Exhibit 5). The number of small banks with less than \$100 million in assets will shrink most, from 13,000 to 7,800. At the same time, the number of large banks with assets in excess of \$1 billion will increase from 230 to 290. Our more recent ARCB study, which polled only the CEOs of large institutions, projected only a 22% decline in the number of banks, to approximately 11,500. In both of these studies, the largest institutions forecast the least degree of industry consolidation.

In terms of market share, bankers foresee further concentration (Exhibit 6). By 1990, large banks, with only three percent of the total number of banks, will hold 65% of the industry assets. Small banks, with 81% of the total, will drop from holding 21% to 12% of total industry assets.

Participants cited three reasons for this banking consolidation. First, the number of bank failures will increase, although this will account

for a minuscule portion of the total consolidation. Second, and more significant, mergers and acquisitions will rise. Over half of all banks expect to be involved in mergers and/or acquisitions between now and the end of the decade. Finally, some consolidation will be more form than substance. Some states currently prohibit statewide branching but permit multi-bank holding companies; the executives expect these states to change their laws, permitting one legal entity where many now exist under the same holding company umbrella.

Expanded Product Offerings

To enhance their competitive position, securities executives said that, through the 1980s, their primary use of additional capital will be to expand product lines and markets. They expect a number of nontraditional products to become standard by the late 1980s (Exhibit 7), including transaction accounts, personal insurance, savings and time accounts (such as asset management accounts) and "automated banking." Securities customers will access these services via automated teller machines and home information terminals. The respondents expressed little interest in either commercial insurance or commercial loans. As an umbrella for customer relationships, securities firms plan to emphasize financial planning.

In contrast, the insurance companies have designed a more introspective plan, focusing first on newer insurance products. Successful insurance products will respond to market needs. Changing demographics and greater consumer awareness will accelerate the trend to flexible

investment-based products of shorter life spans and smaller profit margins. Insurance products will emphasize universal life and universal life with investment options, variable life products, and a variety of annuities including single premium deferred annuities, flexible premium annuities and variable annuities (Exhibit 8).

The life insurance executives plan to diversify into other products as well (Exhibit 9). These include:

- o Asset management accounts
- o Mutual and money market funds
- o Credit life insurance
- o Financial advice and counseling
- o Real estate and home mortgages
- o Commercial loans
- o Securities brokerage
- o Property and casualty insurance

Product diversification is already reality in the banking industry -- daily newspaper ads confirm this. We asked the bankers to rank product diversification along two dimensions -- the probability of entry and the likelihood of success. Two areas seem to offer the most promise. First, banks plan to expand consumer financial services in both the deposit and lending areas. For example, the past few years have seen considerable innovation in variable rate lending and new services, such as home equity lines of credit. The second area capturing bankers' attention is securities brokerage. The majority of bankers said they plan to enter this business

between now and 1990, and they expect to acquire 21% of the total industry market share, defined by transaction volume. Discount brokerage is their principal objective; perhaps they recognize that they lack the research capability to win a competitive advantage in full-service brokerage. They plan to enter this business through acquiring existing securities brokers, developing franchise relationships with brokers or third party service providers, and enhancing the capabilities of existing bank trust departments (Exhibit 10).

Bankers will probably enter several other product areas, although the prospects for success got mixed reviews. These include investment banking, merchant banking, insurance, mutual fund management, and financial counseling and planning. By 1990, over half the banks expect to offer both property and casualty as well as life insurance (Exhibit 2). This is consistent with the insurance executive forecasts which predicted that 49% of banks will offer life insurance, gaining a 6% to 8% market share by 1990. Both bankers and insurance executives expect that most banks will act as insurance distributors rather than as underwriters, although a small number of banks plan to do underwriting as well.

It is intriguing that all three industries plan to become more aggressive in financial planning; whether consumer demand and willingness to pay for planning services can sustain these expectations remains to be seen.

Market Segmentation

Consistent with their marketing emphasis, all three industries plan to become more adroit at market segmentation. As product choices expand and customers grow more aware of financial alternatives, providers need to tailor market strategies to the needs of specific customer segments. This parallels other industries' concern with market segmentation, whether it be Procter and Gamble offering many brands of laundry detergent to meet different needs in the marketplace or airline carriers creating different programs and fare structures to appeal to the business traveler versus the vacation traveler.

Financial services providers must face several issues in developing segmentation strategies. First, will they serve broad or narrow markets? A broad approach suggests that they will serve many market segments differently, depending on capital availability, geographic reach and product depth. For example, Citicorp offers MasterCard, Visa, Diners Club, Carte Blanche and the Choice card. While all of these are functionally similar, they respond to somewhat different consumer needs. Other institutions will follow a narrow strategy, concentrating on a few markets and trying to serve them particularly well. For example, some banks concentrate predominantly on the corporate middle market and the so called "up-scale" consumer market.

The need to develop a sustainable competitive advantage and a reasonable rate of return presents another dimension of segmentation strategy. This involves selecting markets in which potential customers have relatively less buyer bargaining power over the service provider. For example, many mid-sized banks have decided not to aggressively pursue banking

relationships with Fortune 500 corporations because the treasurers of those large firms can exert substantial leverage over the banks, minimizing profit opportunities. Smaller businesses, with less negotiating muscle, may often be more attractive to community and mid-sized banks.

Segmentation responses depend greatly on the existing industry profile. The securities industry has traditionally focused on consumer markets with the highest investable income -- the affluent. Securities executives expect that their primary consumer target market will continue to be households with incomes in excess of \$80,000 per year. They also plan to concentrate on middle market corporations and institutional money managers (Exhibit 11).

The life insurance business has traditionally segmented broadly across all markets by tailoring products to specific customer group needs. Insurers plan to continue in this direction; few plan to exclude markets based on demographic characteristics. As life insurers emphasize financial planning, they will begin to concentrate more on affluent consumers, particularly by adding investment options to insurance policies and by offering asset management accounts.

The banking Delphi study results suggest that segmentation strategies will differ by size of bank. Generally, large banks plan to pursue a very broad national market with different strategies for different segments. They plan to emphasize particularly the up-scale retail and corporate middle markets. Mid-sized banks also suggested a fairly broad but more regional scope, concentrating on the same targets as the large banks --

the up-scale retail and corporate middle markets. Most smaller banks plan to retain their traditional narrow geographic strategy, serving most customers in the same fashion. It is worth noting, however, that a number of small banks have begun to specialize in markets such as high technology companies, agriculture, professionals, women and others.

It is difficult to generalize about market or segmentation strategies. Each institution tends to develop a unique approach, and there are as many strategies as there are institutions. Our Delphi studies and this testimony, however, reflect the general direction of these industries during the next few years.

Distribution Channels

All three industries -- banking, securities and life insurance -- are saddled with distribution channels designed for different, less complex times. All have concluded that their current channels are not wholly adequate to serve them in the evolving financial marketplace. All are looking for ways to broaden their distribution outlets while, to the extent possible, lowering overall cost.

Securities firms have a significant strategic investment in their account executives. They hesitate to take any action that would compromise or cannibalize the important relationship between the account executive and the retail customer. This dependence has kept full-line brokerage firms, for

example, from offering discount services, which would siphon away volume from the account executive, causing the best producers to move to competitor firms. Nevertheless, this is a relatively costly distribution channel, especially as more account executive training is required to build competence in an ever broadening product line.

As the securities firms look forward, they see the account executive remaining the primary distribution channel. The account executive, however, will become more of a financial advisor, assisted by salaried personnel with specialized expertise. This approach is expected to generate additional fees, although it may increase overhead. Because insurance products fit well within existing account executive distribution systems, securities firms tend to be more interested in insurance products, such as annuities, than banking products.

Securities firms also expect to expand distribution channels to direct mail, personal computers and joint ventures with other financial services providers, such as banks and insurance companies. Joint venturing is a particularly noteworthy trend. Firms in different industries may be able to form alliances without resorting to mergers and acquisitions. Banks and brokers, for example, may be able to distribute each others' products.

The life insurance business is positioned much like the securities industry. Life insurance companies have traditionally depended on captive and independent agents as primary distributors. In ranking future distribution outlets, insurance executives project that, at the end of the decade, captive and independent agents will each account for only 28% of

total premiums. Other sources will become increasingly significant (Exhibit 12). Fifteen percent of premiums will be generated through securities brokerage firms, 9% through banks, 8% via direct mail, 4% through retailers and 8% through other channels. In this environment, insurance companies will adopt an approach similar to that of securities firms, using agents more as financial planners, supported by selling teams with specific expertise.

Broadening insurance distribution channels may create a trend toward life insurers becoming manufacturers of their products and looking elsewhere for distribution and retailing. This is consistent with the forecast that only 28% of premium volume will be generated by captive agents.

Banks face a different kind of distribution dilemma. Today, they find themselves saddled with antiquated branch networks, many of which are ill-suited for broadened product lines. Banks once built palatial and stately offices to enhance a solid and stable image. Today, as customers become increasingly mobile, the occupancy cost of these facilities is unacceptably high.

As a result, banks plan to follow a number of distribution strategies. First, many are closing unprofitable or unproductive branches. Second, banks are beginning to reconfigure existing branches, in many cases down-sizing them and adding greater technological convenience for self-service banking. Third, banks increasingly look to direct mail as a means of selling and servicing products such as credit cards and equity loans. Almost every week, for example, I get mail solicitations from financial institutions all over the country offering still more credit

cards. Joint ventures with other financial services providers represent a fourth distribution approach. These may include arrangements with insurance companies and securities firms to distribute their products in the bank branch. They may also include relationships with other banks, particularly to support distribution through technology such as automated teller machines, point-of-sale networks and home banking.

This last point is particularly important. Technology enables financial institutions to provide customers with access to financial services independent of fixed office facilities. Nevertheless, the coverage required to make technology sufficiently convenient and acceptable to the public is beyond the financial capability of any single institution. As a result, we have seen the formation of many networks of financial services providers, sharing development and delivery of technology-based financial services. These networks enable small institutions to offer the same customer convenience as large banks that have far greater resources to invest in technology.

Financial Supermarket

One of the consistent ideas resulting from diversification, changes in distribution, and waves of new entrants has been the concept of one-stop financial shopping -- the financial supermarket. Is the financial supermarket the wave of the future? The answer is both "yes" and "no."

On one hand, diversified financial service providers have already emerged. My bank, for example, offers a variety of deposit services, loans

(both secured and unsecured), transaction cards for automated teller machines and point-of-sale services, home banking services, discount brokerage, municipal bonds, IRAs, financial planning and insurance. American Express offers me travel-related financial services, securities, insurance and other financial services. Sears offers brokerage, real estate, securities, banking services, credit cards and insurance. Consequently, one could argue that the financial supermarket already exists; I could satisfy most of my financial needs at a single location.

On the other hand, the term "supermarket" seems a misnomer. When shopping for food in the supermarket, I tend to fill my basket with a wide variety of foods to meet most of my needs for the next few days or the week. Even then, I may go to the fish market for seafood and to my wine merchant for special wines, and I shop at several supermarkets. With respect to financial services, I usually purchase only one financial service at a time. I typically do not require a mortgage loan and an automobile loan at the same time. Consequently, the financial supermarket concept might better be replaced with the notion of a financial "shopping mall," where I make individual purchases at a single location, but may only shop for one specific item.

Beyond the metaphors, however, most of our survey respondents have additional reservations about the idea of one-stop shopping. They cite several reasons for thinking that a totally diversified strategy is difficult to execute:

- o Most providers lack management expertise in all business lines.
- o They would have to reformulate their compensation policies to attract and retain key staff.
- o Finding adequate capital might be a problem.
- o Varied customer desires are difficult to serve comprehensively.

In a recent McGraw-Hill Research survey of 2,000 Business Week subscribers, 79.2% indicated that they had heard of multi-service financial centers. Of the total sample population, however, only 32.6% preferred to obtain their financial services from a single institution. 31.9% chose separate institutions that offered specific services. Finally, 34.4% expressed no preference. As financial sophistication increases, customers become more willing to shop around to find the institution best suited to their immediate need, and they happily shop elsewhere for their other financial needs.

As a result, most of the institutions responding to our surveys reported no plans to become financial supermarkets. In fact, many plan to specialize in order to capitalize on existing or potential strengths. This strategy is as important as the supermarket strategy. We have seen, for example, Bankers Trust sell off its retail branches to become a wholesale commercial banking institution. Several weeks ago, Wells Fargo Bank announced it will substantially shrink its international banking business to focus on the California retail and middle market segments. In the insurance

business, firms like USAA are broadening their products but continuing to limit their customer segments -- in USAA's case, the military.

Financial service providers have many options between narrow specialization and the supermarket. They may select from a wide range of customer groups based on demographic characteristics and geography. They may choose to serve many or few customer functions related to transaction capabilities, lending, investment and protection. They may choose a number of delivery or distribution options, ranging from the agent or account executive, to the branch, to technology. The financial supermarket is only one of many choices available to financial services competitors.

Conclusion

Market forces are creating both the need and opportunity for financial services providers to change traditional roles. In fact, to survive, change is almost mandatory. Will Rogers observed that "even if you're on the right track, you'll get run over if you just sit there." Failure to change in the financial services industry is likely to lead to stagnation and decline. For many institutions, responding to change will lead to success, although diversification carries with it new management challenges.

As financial institutions redefine their competitive positions, our regulatory system must continue to protect the public interest. I hope this testimony will assist you in establishing a legal and regulatory structure to deal with the financial marketplace of the future.

Exhibit 1 Securities Delphi

Market Entrants

All segments of the financial services industry will enter the securities business

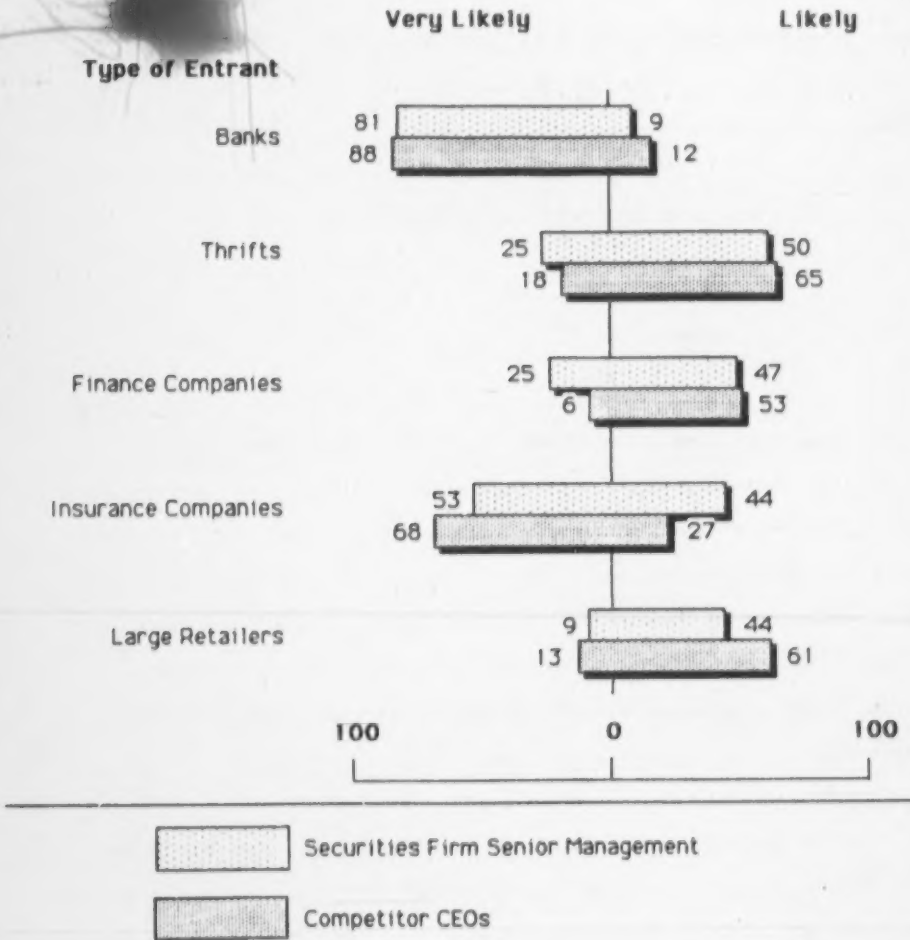
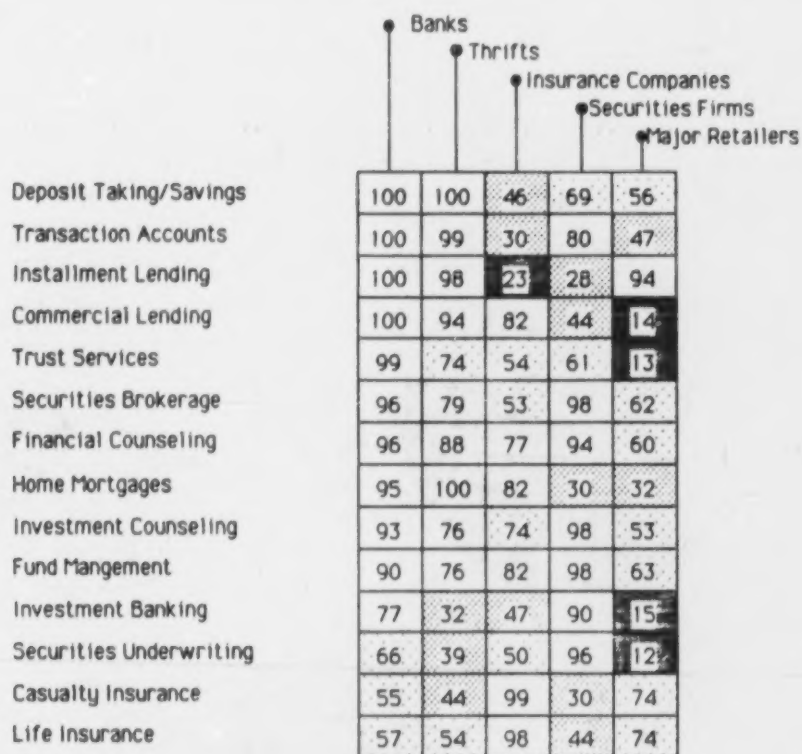


Exhibit 2 Banking Delphi

Differences Among Financial Service Providers in 1990

Providers maintain traditional product focus



Key - % of Panelists Expecting Each Provider to Offer



75% or more



50% - 74%



25% - 49%



Under 25%

Exhibit 3 Securities Delphi

Industry Revenue Concentration

Concentration of revenue among the Top 10 firms is expected to continue to increase

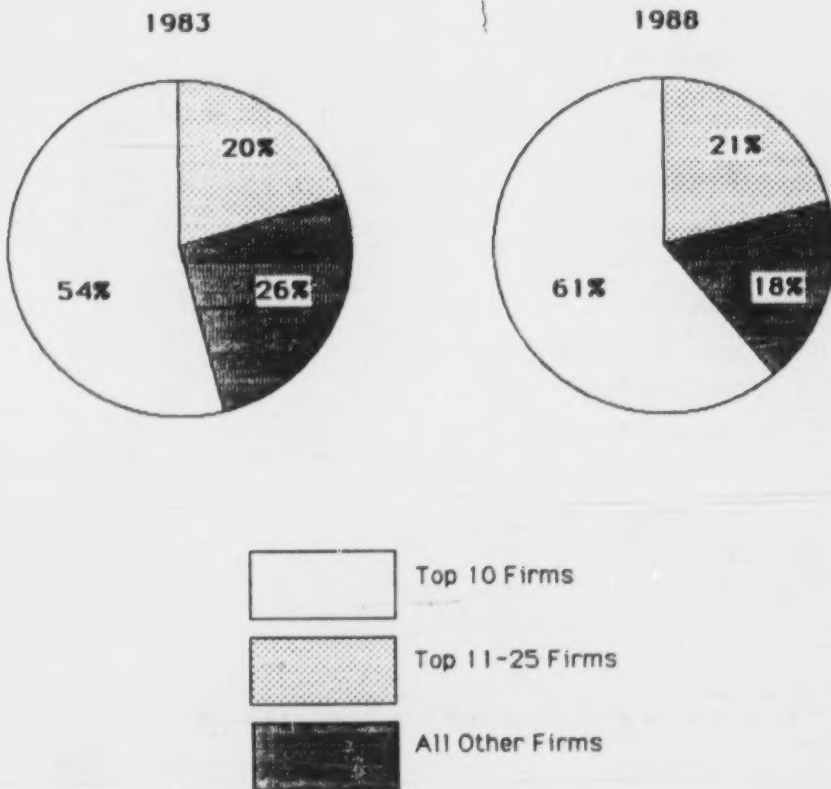
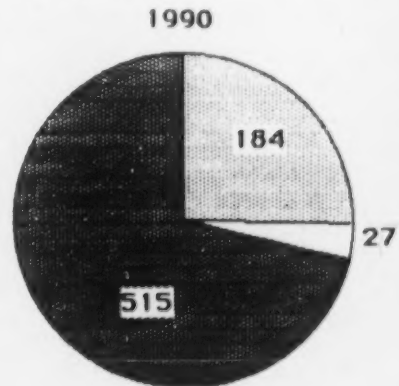
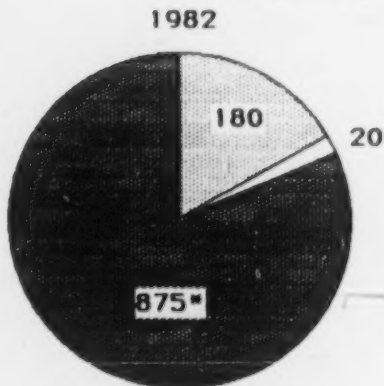
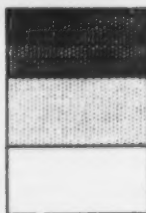
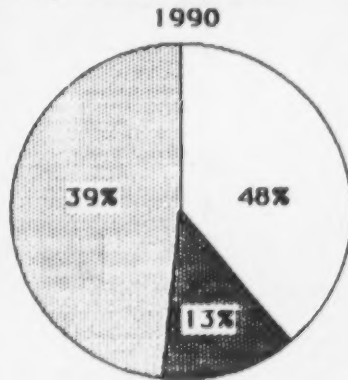
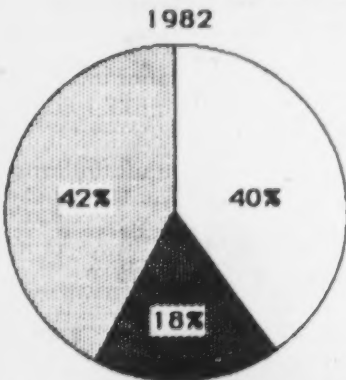


Exhibit 4
Insurance Delphi

Number of Life Companies by Size



Share of Insurance in Force by Company Size



Smaller Companies

Midsize Companies

Larger Companies

* Estimated number of active, non-captive operating companies

Exhibit 5 Banking Delphi

Number of Banks by Bank Size

Number of smaller banks to decrease sharply

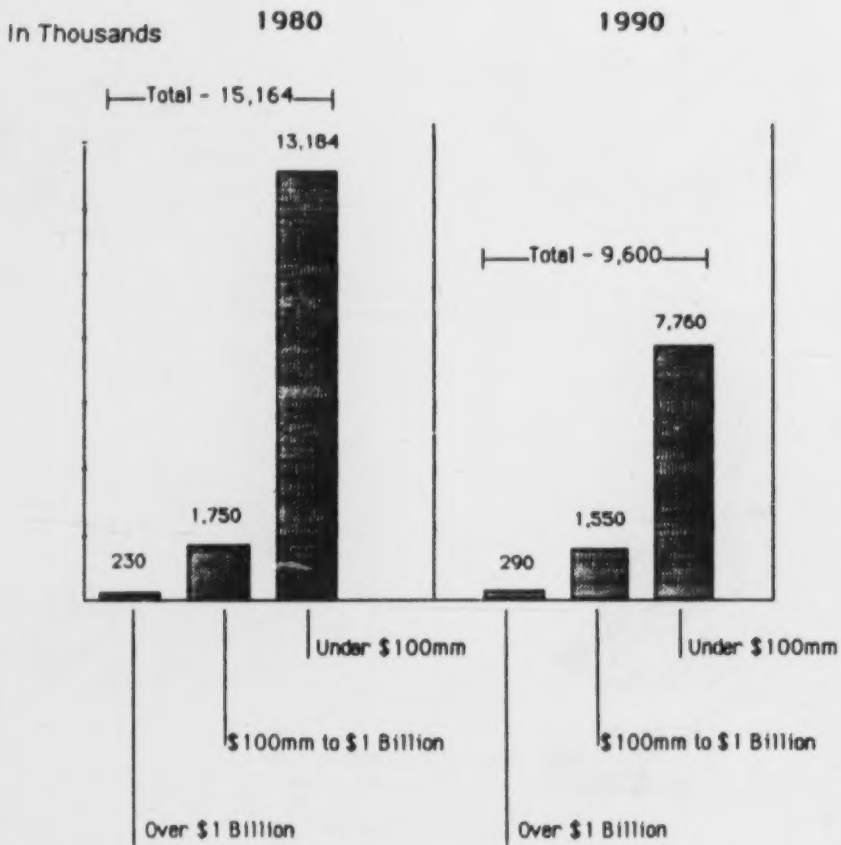
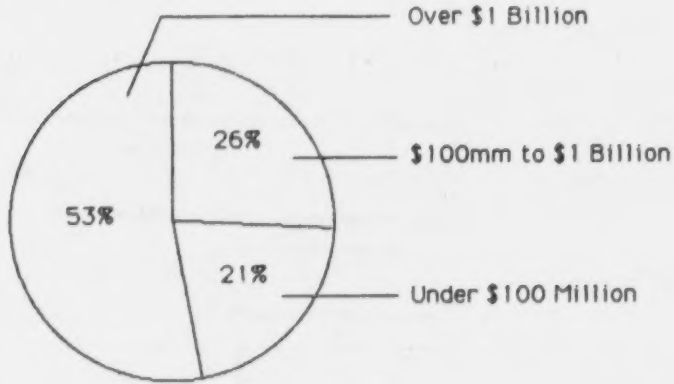


Exhibit 6 Banking Delphi

Percentage of Industry Assets by Bank Size

Industry assets shift to larger banks

1980



1990

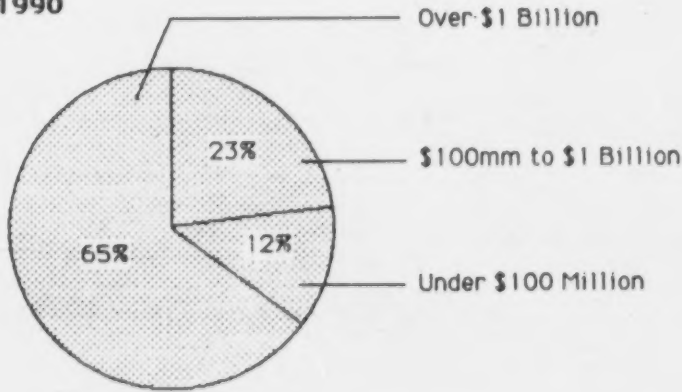


Exhibit 7 Securities Delphi

Standard Products of Securities Firms in the Late 1980s

Securities firms will not offer credit type products

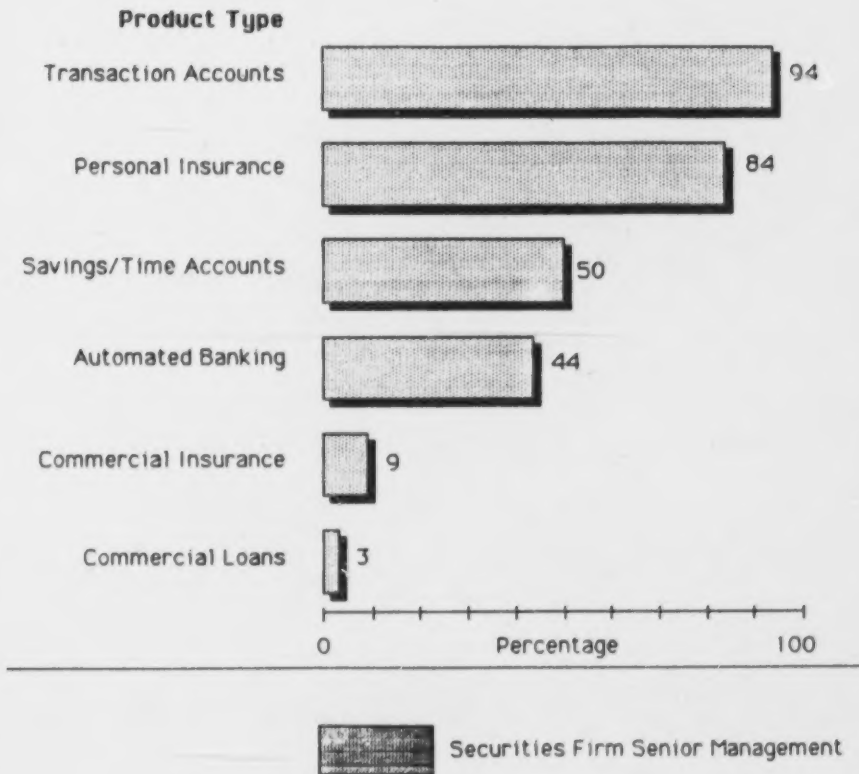


Exhibit 8 Insurance Delphi

New Product Offering in 1990

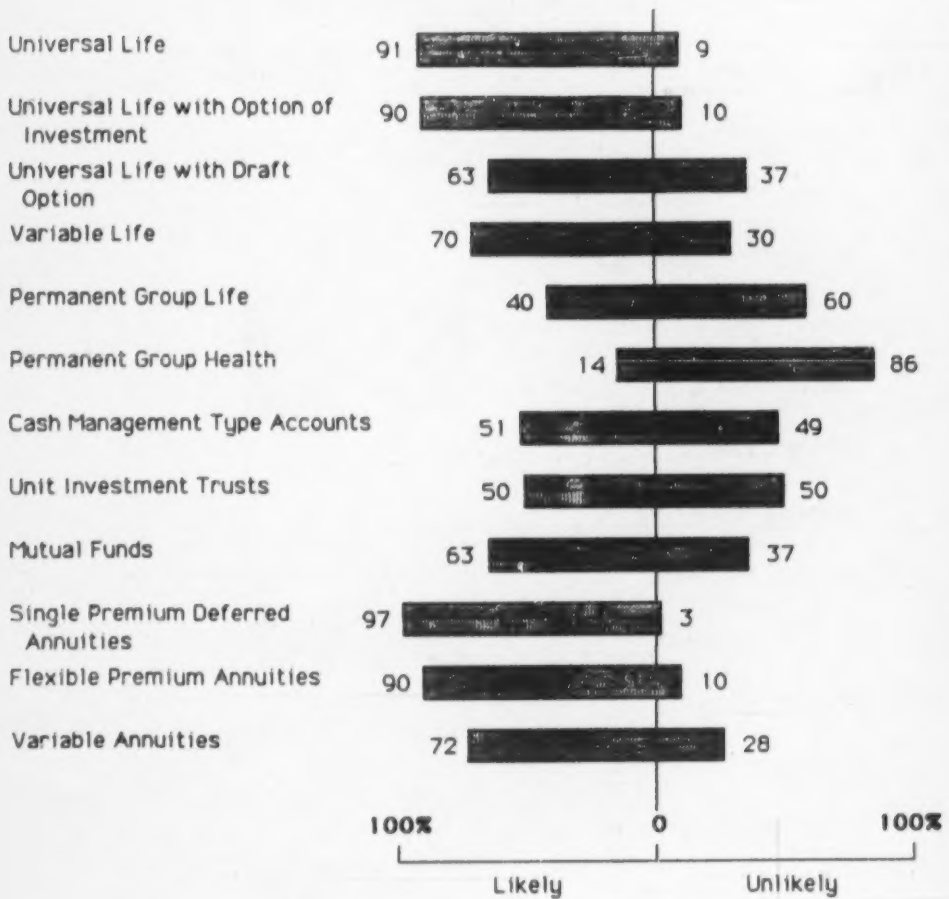


Exhibit 9 Insurance Delphi

Products of Financial Services Providers

Percent of Providers likely to offer financial products/services

Product/Service	Life Companies	Banks
Life Insurance	100	49
Credit Life Insurance	52	84
Property and Casualty Insurance	41	37
Deposit Taking/Savings Accounts	23	100
Consumer Installment Lending	12	98
Home Mortgages	41	91
Commercial Lending	46	98
Security Brokerage	36	66
Security Underwriting	9	41
Trust Services	25	86
Financial Counseling and Advice	66	83
Mutual/Money Market Fund Mgmt	61	79
Investment Banking	16	67

75% OR MORE
 50% - 74%
 25% - 49%
 UNDER 25%

Exhibit 10 Banking Delphi

Means of Bank Entry into Securities Brokerage

Banks will employ various strategies to enter brokerage

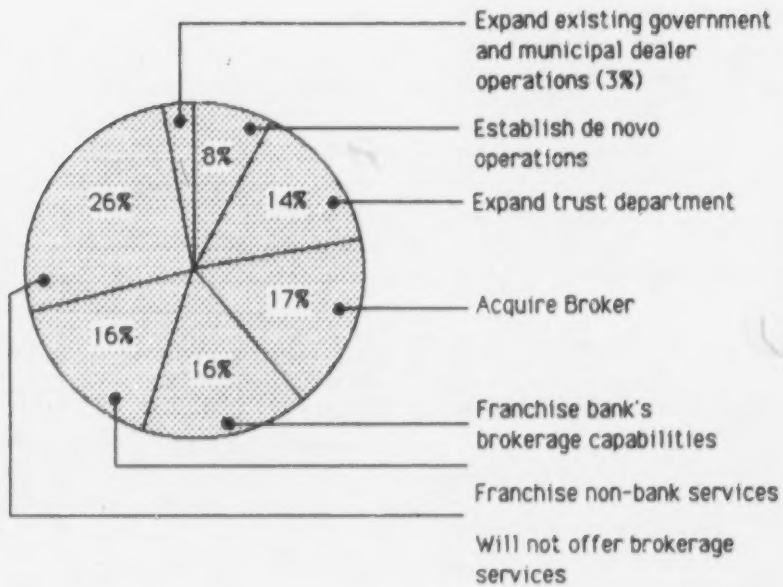


Exhibit 11 Securities Delphi

Ranking Importance of Market Segments

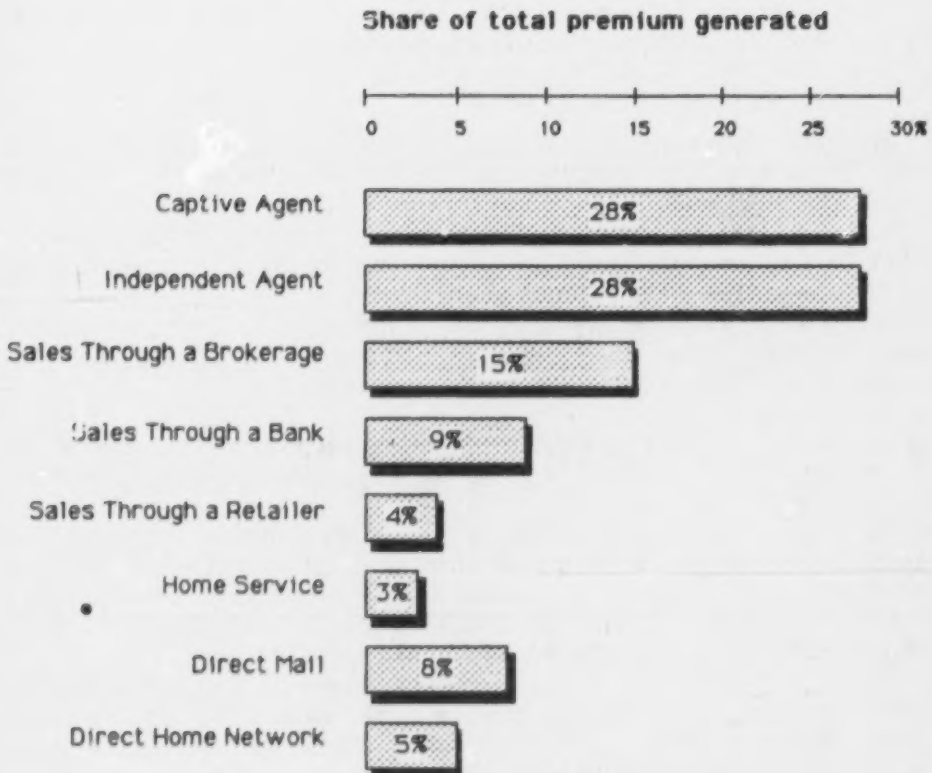
National full line and regional firms have similar target markets

Market Segment	National Full-Line Firms	Regional Firms	Large Investment Banks
Retail Customers (Income Greater than \$200,000)	1	1	4
Retail Customers (Income \$80,000 - \$200,000)	2	2	7
Middle Market Companies	3	3	6
Money Managers	4	5	1
Retail Customers (Income \$50,000 - \$80,000)	5	6	9
Government Bodies	6*	7	2*
Fortune 1000 Companies	6*	9	2*
Small Businesses	8	4	10
Retail Customers (Income Less Than \$50,000)	9	8	11
Foreign Companies	10	10	5
Foreign Governments	11	11	8

* Indicates a tie within a panel group

Exhibit 12 Insurance Delphi

Life Insurance Distribution Channel Market Share by 1990



The CHAIRMAN. Thank you, Mr. Friedman.

Mr. Gunderson, you have had the opportunity to be before this committee on many occasions in a different capacity than you are here today, but not much has changed. We hold new hearings every year and the discussions are essentially the same. I suppose there's more people after the last 4 or 5 years who have finally decided that there is great change going on in the financial services industry who couldn't be convinced 4 or 5 years ago when we started talking about this. But one of the myths that continues over, and over, and over again is that somehow deregulation is causing all of this and we must stop it.

Hobart Rowen had a column just in the last few days and it was a very well written article describing the nature of the problems but one of his solutions was to stop deregulation.

FAILURES NOT CAUSED BY DEREGULATION

In your experience in many capacities, can you attribute any of the 79 bank failures last year or the list of troubled institutions to anything that was either done in the 1980 deregulation bill or in 1982? Are you aware of any examples of freeing deposit interest and so on, the relatively few things we've done in deregulation, that caused this difficulty out there?

Mr. GUNDERSON. Well, first, Mr. Chairman, I did experience a sense of *deja vu* as I sat here this morning and talked about the issues that I recall we have been discussing for some time before this committee.

In answer to your question, no, deregulation, to the best of my knowledge, has not been the cause of any of the failures or problem institutions.

As I mentioned in my testimony, it comes down to in many cases poor management. Banking and the financial services area is a risk business and we have had problems in the economy, some of which have been created by volatile and high interest rates, and segments of the economy have suffered and banks have suffered.

So it's a combination I think in many cases of poor management, unfortunately, or in another case of banks such as back in the Midwest, if you're in a small community where 100 percent of your economy revolves around agriculture, it's pretty tough to maintain a bank in that type of environment.

But deregulation has not been the cause.

The CHAIRMAN. But most of them in a general sense have had problems because of bad loans, right?

Mr. GUNDERSON. Right.

The CHAIRMAN. Poor risk assessment in traditional banking areas have had nothing to do whatsoever with what we have either done or are attempted to do in deregulation. So I'm amazed that we still have noted columnists like him and others who continue to perpetuate what is really a myth and has no basis in fact. On the contrary, let me ask you this—or any of you can reply—if we had not removed interest rate ceilings in 1982, what do you think the condition of the banking industry would be in competition with the new boys on the block?

Mr. GUNDERSON. I think, Mr. Chairman, I'm confident you would have seen some severe liquidity problems in banks simply because of their inability to compete for deposits, not only banks but thrifts as well. They were able to compete and have attracted a good deal of money back into their institutions and into the communities they serve.

The CHAIRMAN. As a matter of fact, more than \$200 billion flowed out of the traditional depository institutions until we deregulated interest rates when more than \$300 billion flowed back in rather rapidly.

The reason I bring that out is just the opposite. I firmly believe—and I know I'm suspect because of being the author of some of the legislation with Senator Proxmire in the 1980 bill—but the facts are just the opposite. Had we not made some of those decisions, I think you would have far more than 79 banks who failed last year because they simply did not have the tools to compete with those who traditionally, as Mr. Friedman explained the compartmentalization, of everybody doing their own specialized thing—when the insurance companies and securities firms started to get into bank-like services, as they like to refer to them rather than really being banks, there was a severe liquidity problem developing.

So it's one of those things that we sometimes see in politics that amazes me, that the argument against doing something is totally the reverse to the actual fact of the situation.

Mr. Friedman and Mr. Gunderson, would you agree with that analysis?

Mr. FRIEDMAN. Our view, Mr. Chairman, is that, based on the study findings and the experts that we have talked to, that deregulation is a consequence, not a cause, of change in these industries; that there are in fact compelling market and economic forces driving the behavior that we are seeing in all, and they are all rational forms of behavior.

The CHAIRMAN. Mr. McCormick.

Mr. MCCORMICK. I would agree. In fact, we believe that if deregulation of the thrift industry hadn't occurred the situation would have been even worse. If you're boxed in, you do what you can do. Interest rate bets were the only way you could get a spread, given the way they were legislated. So being boxed in, they did what they could—and of course that's the problem now.

The CHAIRMAN. Well, a lot of people are certainly looking for a scapegoat and rather than deregulation being the cause, it is a reaction of the very rapid changes in the marketplace which we have not even begun to keep pace with in the 2½ years since that occurred. I believe we are further behind the power curve than we were at the time. There are incredible changes of new services and new products being offered, and I have never been critical of that—the consumer has benefited from those innovations—but to continue to have Government keep one segment of an industry down by not allowing it to be competitive is counterproductive to say the least. As we wring our hands and tear out our hair about the problems of the thrifts in Maryland and Ohio and the whole condition of the financial services industry, those who oppose trying to rationalize and set policy and prefer closing a couple of loopholes will only get us further and further behind that power curve until it is

absolutely impossible to rationalize it. Meanwhile, State regulators, Federal regulators, and the courts make decisions that the Congress of the United States should be making.

It is frustrating, very frustrating to read articles like that, that somehow give the impression that deregulation is the cause, when you have such a dynamically changing marketplace. Deregulation, at least in my opinion and certainly the majority of this committee and the Senate—not the House, but the Senate—is an effort to respond to that change, not to cause it.

Any other comments any of you wish to make on that very general point?

BEHIND THE POWER CURVE

Mr. McCORMICK. I would agree with your notion that we are further behind the power curve. I think the rate of innovation going on now is 5 times higher than it was as recently as 5 years ago.

The CHAIRMAN. I certainly would agree with that.

Mr. McCormick, your testimony went into great length talking about the need to become a more efficient intermediary and primarily through securitizing the balance sheet.

If this does take place, is there any need for deposit insurance on those types of securitized instruments?

Mr. McCORMICK. Essentially, I think you are getting to the subject of how should risks be handled and diversified.

We feel that the financial innovators are coming up with new ways all the time of doing that. The risk is being diversified by pooling the credits together. The risk is being diversified through forms of financial guarantees which I suppose by analogy would represent things similar to something like the FDIC. I think that all these forms will exist and some will be better suited to certain market segments than others. So I would not be predicting the total demise in the need for FDIC-type insurance. We think there will be an evolutionary decline in the level of the current form of FDIC insurance because we see the overall level of balance sheets in banking shrinking through this securitization and therefore less deposits and therefore less need for specifically that kind of insurance. As a generic form of risk diversification, though, I see a role for it.

The CHAIRMAN. Mr. Gunderson, you talked about specifically in Ohio and Maryland if we had had interstate banking that those problems could have been handled in a more orderly manner. I would not disagree with you on that, but we have had a good deal of testimony this year about full interstate banking or at least triggers into interstate banking from regional compacts. The Chairman of the Federal Reserve would like to have a trigger.

But despite the fact that I would agree that it's easier to handle those merged institutions or to find merger partners across State lines, how would that set on Wisconsin with your small bankers talking about interstate banking or triggers?

Mr. GUNDERSON. Well, I think, Mr. Chairman, there's been certainly a definite change in the attitude of many bankers toward interstate banking over these past several years. I think they recognize it as becoming more and more of a necessity and having

some value. As one who still has an interest in a \$26 million community bank back in Wisconsin, I don't view interstate banking as a threat to my bank.

I think it was proven in my State of residence now of New York when they opened up to full statewide branching there and money center banks from New York City marched into the upstate area and there was a great deal of concern about what was going to happen. What has happened is many of them found that the folks in upstate New York, there were community banks serving that area and serving it well and the money center banks couldn't compete with them. In fact, they have ended up selling off and closing some branches up there.

So I think there will always be a place for the well-run community banks and a need for them in this country and interstate banking will not change that, but it does provide opportunities as banks move ahead and we see all the changes that are brought about by these market forces, if they do feel a need to merge or to become part of a large organization to remain viable, it gives them a broader base of opportunity and I think it serves the areas of the community in a much better sense.

The CHAIRMAN. There is no doubt that a lot of small bankers have changed their minds in the last 5 years from total opposition to more who share your opinion, but it would still be my opinion that that's a relatively small number. How many of the under \$100 million banks in this country do you think would share your viewpoint that they have no fear of full interstate banking?

Mr. GUNDERSON. There's no way that I could assess that and come up with a number, Mr. Chairman.

The CHAIRMAN. I'm not asking you for a specific number. I'm asking you for a very broad guess.

Mr. GUNDERSON. It's difficult to say, but in meetings I've attended and discussions, I can see a very definite swing in the mood and certainly there is still this strong opposition to it.

The CHAIRMAN. I sense the changing mood too, but I would have to assume that overwhelmingly the vast majority of independent bankers still oppose it. Would you agree with that?

Mr. GUNDERSON. I really don't know. I think the actions that have taken place in the State legislatures in the number of States that have ratified or approved regional banking and more and more of them are moving ahead, and there's been some pretty intense discussions in those States, makes a fairly strong case that the opposition has backed off and there is more support for it than was there in the past. If there was not, they would never have passed in these States.

The CHAIRMAN. Except like in Utah, where my legislature approved the compact legislation in 10 other Western States on a reciprocal basis, including California. There is the difference. They are still opposed to interstate banking. They don't fear Nevada, Colorado, Arizona, and so on, but they do fear Bank America in California. So I think that's the difference.

My time is up. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman. Mr. Chairman, it's interesting that Ken McLean, our very shrewd and thoughtful

minority staff director, saved a yellow clipping from Hobart Rowen back in 1979. Hobart Rowen said:

It may not be possible in the real world to do away with ceilings all at once, but they can be phased out and exceptions can be made for \$10,000 deposits and ceilings can be raised for traditional kinds of deposits and depositors.

Well, we did exactly that. We followed Rowen's advice. Now Hobart doesn't seem to agree with us.

The CHAIRMAN. Maybe we should send him a copy of his column so he can remember what he said before.

Senator PROXMIRE. I'm not sure I agree with you, Mr. Gunderson, on your statement about how New York City had an opportunity to branch upstate and not very much happened in terms of concentration.

CONCENTRATION OF POWER

Walter Wriston is such an overpowering figure that he can get away with that kind of assertion and nobody challenges it, but the fact is that in New York the banks with less than \$100 million in assets have less than 1 percent of the assets of the banks generally throughout the State, and there's far greater concentration than any other State in the union.

So it seems in that case the banks were able to move in and move in vigorously and take over which I think is unfortunate because I am very strongly in favor of local ownership, if we can possibly maintain it. I think the value of local ownership is great and I think you're a fine example of that.

Mr. GUNDERSON. Thank you.

Senator PROXMIRE. Mr. McCormick, much of your argument that you presented to us on bank financial performance is based on banks selling well below book value. You conclude that the market is placing a low value on bank stock because of the restraints of regulation and we, therefore, need to lift these restraints.

It seems to me there's a more plausible explanation for the low price of bank stock leading to exactly the opposite conclusion. The bank stocks are depressed because investors are worried about the large volume of shaky foreign and energy loans by our large banks and that would seem to imply that we need more regulation.

The performance in Penn Square, the performance of Continental Illinois and so forth have made people a little shaky about banks. Certainly the stockholders in Continental Illinois took a tremendous bath and that was not because of excessive regulation.

Mr. MCCORMICK. Interestingly, if you go back to the Continental Illinois annual report of 1981 you will find that they sought an 18-percent return on their shareholders' equity (which our analysis of the capital asset pricing model suggests was a good number at that time), and they also said that they wanted to be the dominant bank in financing corporate America. Thus, Continental's strategy was to earn a high return on equity financing large corporates in America.

What did that strategy push them into doing? We would maintain, because the banking formula is outmoded, to earn those acceptable returns, you need to increasingly take on more risk and the result is now history. In other words, their strategy was flawed

because the banking formula does not allow that strategy to succeed. Because they were boxed in, they took on more risk to get the returns that the capital markets said they needed.

Senator PROXMIRE. Well, that may have happened to some banks. It certainly didn't happen to Morgan Guaranty. It went just the other way. They did better. Furthermore, the statistics that you gave us contradict the statistics that I have here from the Federal Reserve Bank in Minneapolis which shows that from the early 1960s there's been a fairly steady increase in the rate of return for banks on average. As a matter of fact, it went from 9 percent in 1963 to 12.2 percent in 1981, the latest year for which they have figures. This was a publication in 1982.

So they are showing that banks are having a better return, doing better, not worse.

Mr. McCORMICK. My statistics are for the top 30 banks in the country and when you compare a bank's return on equity versus the return required, based on our analysis using the capital asset pricing model to determine what that required return is in the equity market, that shows a rather sharp systematic decline in performance, as was indicated in exhibit B of my testimony.

Senator PROXMIRE. Who computes the required rate of return. I show the actual rate of return, not the required rate of return. What does required rate of return mean?

Mr. McCORMICK. Well, required return the way we calculate it—and again, it's the capital asset pricing formulation as the academics define it, essentially consists of three components, one of which is inflation expectation related and that causes the required return to move up and down, as do the rates on long-term financial instruments.

Senator PROXMIRE. There's another interesting contradiction. On page 3 of your statement you say that the banks' financial performance is now poor and has been continuously sliding for 20 years. That contradicts what the figures show for all commercial banks that the Federal Reserve Bank of Minneapolis shows.

Furthermore, a recent article by the American Banker observed that the 1984 pay of all bank executives increased about 8 percent and the 10 highest paid bankers got a hefty 10.5-percent increase. Of course bank executives' pay is often tied to financial performance, especially at the top levels.

If banks are performing so poorly, why are they increasing the pay of their top executives so sharply? Incidentally, I have here some of the top people. Willard Butcher was able to get along on \$889,000 a year; J.J. Pinola, \$904,000; R.J. Flamson, \$919,000; Walter Wriston, \$928,000; and Lewis Preston from J.P. Morgan, \$1,018,000. That was their compensation.

Mr. GUNDERSON. That makes me wonder why I left banking, Senator.

Senator PROXMIRE. Sure does, but you're probably doing better than that now.

Mr. McCORMICK. When we look at compensation levels, we like to see what the chief executive has done in terms of increasing the value to shareholders. Using that model we would not necessarily agree that all those executives might deserve that compensation level.

Senator PROXMIRE. But throughout the country it's an 8-percent increase. That indicates that the directors who set their salaries thought they had done pretty well.

Mr. McCORMICK. In very short term, for a number of reasons, interest rate decline being one, an exogenous factor, performance has improved. I would like to respond to the statistics you quoted in writing if I may.

[Information supplied for the record may be found on p. 820.]

Senator PROXMIRE. Fine.

Mr. Gunderson maybe you can help me on this. On pages 5 and 6 of your testimony you make a strong argument for interstate banking but you don't address any of the concerns about economic concentration.

We have in Congress, as you know, a concern about that. If Congress did move toward authorizing interstate banking, would you agree with Chairman Volcker that we need concentration limits in any such legislation to prevent undue concentration of economic and consequently political power?

LIMITS ON CONCENTRATION

Mr. GUNDERSON. Senator, it seems to me there would be two factors that would influence or affect the potential for excessive concentration and certainly the antitrust provisions that are in place and may even be modified is part of the process and the other is simply the available capital of the banks in the country which places limitations on the type of acquisitions and the number of acquisitions that banks would make. Certainly through mergers you could have things that facilitate it, but as far as outright acquisitions, a large money center bank going across the country—

Senator PROXMIRE. In general, as a matter of principle, would you feel that Chairman Volcker is right that we ought to set some limits on concentration?

Mr. GUNDERSON. I think certainly there needs—I would not like to see this country reach the point that Canada or some of the European nations have where it's concentrated in five or six banks.

Senator PROXMIRE. That's right, and we are unique. That's what appeals to so many of us, the fact that we do have locally owned banks and they do a big business. In Canada, as you know, there are five or six banks that do 95 percent of the business. The same thing is true in the United Kingdom, Japan, Italy, and Germany. I think we do better.

Mr. Friedman, would you like to comment?

Mr. FRIEDMAN. Senator, if you recall the numbers I quoted, the banking executives forecasted a decline to 9,600 banks by the end of the decade. A more recent banking study predicted 11,500. And I can't tell you which number is right.

But when you talk about concentration and the risks of concentration, I begin to think about Canada or the United Kingdom where you have a small number of banks entirely dominating national markets.

In the United States, even when it's changed, we still end up with phenomenal levels of competition. I come from California which may be a microcosm, although no one ever accused it of

being representative of anything. With five banks accounting for perhaps 70 or 75 percent of the market, we still have more independent banks than almost any State in the country and we actually increased the number of community banks last year.

I think we have left safeguards in place dealing with the concentration issue. We also have antitrust laws that can be applied, and I have a question as to how you define the market. Is Sears part of that measure because I can now go to Sears down the street and obtain almost all the services that I can obtain from Bank of America? I am not convinced that those measures need to be produced in legislation, although concentration has to be considered as part of it.

Senator PROXMIRE. It has to be and that's what Mr. Isaac told us, to rely on the antitrust laws, well, good luck. We've been working on those antitrust laws for a long time and they seem to get feebler. Look at the automobile industry. Three firms do 97 or 98 percent of the business. They do an overwhelming proportion of it at least. The head of one of the biggest banks in the country was in my office not long ago and he said that in his view we would shortly, if we kept on going, have only 300 banks in this country, and he said that would be great. It wouldn't be great in Oshkosh or Osceola. I think it's great to have local people who live in the community and grew up in the community and know the people in the community have an opportunity to own banks, and I don't see that we're making much of a sacrifice in trying to preserve that by holding down the concentration.

Mr. FRIEDMAN. Senator, I agree with you entirely on that matter, but in any of the forecasts, you still end up with somewhere in the ballpark of 10,000 community banks by the end of the decade. I can't tell you whether the number of 15,000, 10,000, 8,000 is right, I don't know. But with that many institutions and that many branches, I as a consumer have such a phenomenal choice and the ability to go to a locally owned institution to take care of my needs—

Senator PROXMIRE. Well, that's the way we want to keep it.

Thank you, Mr. Chairman. My time is up.

The CHAIRMAN. I might suggest that if that banker who estimated 300 banks is making \$1 million a year, he ought to have his salary vastly reduced because I have never heard that kind of an estimate from anyone.

Senator PROXMIRE. He's making \$800,000 a year.

The CHAIRMAN. Well, he's overpaid by about \$799,000 then.

Senator PROXMIRE. He said that would happen if we repealed all restrictions on interstate banking.

The CHAIRMAN. I still totally disagree with him. The reason I do is if you do look at California, and look at New York, and you look at some of the highly concentrated States where you would assume by that that Bank America would swallow everybody in California and they simply have not been able to do that at all. I think there would be some shrinkage and I would agree with you on the fear of concentration but I just can't imagine anybody making the assertion that if we moved to full interstate banking that we would end up with 300 banks in this country. I don't accept that at all or anything close to that kind of a number. So I repeat, his pay could be

reduced by \$799,500 paying him \$500 a year for his lack of judgment.

Senator Gorton.

Senator GORTON. Mr. Friedman and Mr. Gunderson, I read Mr. McCormick's intriguing testimony as saying that the banking business as presently constituted is both inefficient and dying, that the Congress really should welcome the drastic restructuring which that entails and that all regulators or the Congress will accomplish by increasing capital requirements for banks is to speed up and accentuate that inefficiency and that dying. I don't believe, although I haven't been here all the time, that either of you has been asked to comment on his testimony and I'd like to hear your comments. I hope I haven't mischaracterized Mr. McCormick. If I have, you can correct me.

BANKS ARE DOING WELL

Mr. GUNDERSON. Well, Senator, I certainly don't feel that banks have been inefficient or certainly that they are dying. My feeling is quite the contrary, as I indicated in my statement. I think, all things considered—the competitive environment they are operating in, the volatility we have experienced in interest rates over these past years along with the movement toward deregulation of deposits—that with what they have been able to have on their table they have done a pretty good job of it. What inefficiencies are there are created by legislation that prevents them from becoming more efficient.

Mr. FRIEDMAN. Senator, I am not prepared to predict the demise of the banking industry. If I might recharacterize Mr. McCormick's comments, we have situations where market forces are changing the ground rules in terms of how we serve the marketplace. In any other industry when demands of the public and the consumers and buyers of the products change, companies typically redefine their business, redefine their products, innovate new products, and change their old way of doing things.

We have a situation in the financial services industry where we have regulatory prohibitions that inhibit such change and obviously many have gotten around those prohibitions through loopholes. The largest institutions have the capacity to utilize the loophole route that many small institutions don't. So we end up with diseconomies and I think that if we can take a broader look at the changing marketplace and let the regulatory process catch up we will end up with a healthier industry and greater efficiencies.

Senator GORTON. Mr. McCormick.

Mr. MCCORMICK. In reacting to your summary which I generally agree with when we characterized the banking mode as inefficient, it is because they have what I called the excess baggage of their financial structure attached to their back. We're not commenting on the recent moves of management to become more efficient in an operating cost sense. Nor do I think our prognosis will occur overnight, although I do think it is time to act now.

So dying is perhaps a bit too strong a word. However, I was in a meeting in December where a chief financial officer stood up in front of the assembled body of about 200 people and said, "Gentle-

men, we are not going to grow in assets next year. We can't afford it. We can't raise the equity." That was a shock. I don't think they're alone. So that's certainly the start of something.

Senator GORTON. Thank you.

Mr. Gunderson and Mr. Friedman, you didn't comment on the part of my question that related to increasing the reserves or the assets of banks and whether that exacerbates the problems that banks have.

Mr. GUNDERSON. The increase in capital requirements, Senator?

Senator GORTON. Yes.

Mr. GUNDERSON. In my testimony I made reference to the proposed increase by both the Treasury and the FDIC to increase capital to 9 percent and I feel this would be a very inefficient approach to the safety and soundness issue of banking.

For one thing, as I mentioned, it would create a need for \$60 billion in capital which for the most part would be unproductive, would create tremendous problems for smaller institutions who don't have access to capital markets. They would have to borrow it from correspondents and others. And if you look at most of the bank failures, 9 percent capital wouldn't save them and neither would 6 percent capital. So I think you need a sound and prudent base for capital, but what you need even more dramatically are opportunities for banks to generate other forms of income to increase their equity through retained earnings and build a solid base and serve their customers in the communities in a better sense in that respect.

Senator GORTON. Mr. Friedman.

Mr. FRIEDMAN. Senator, I agree with that. One of our study findings indicated that historically 85 percent of banks' capital has come from internally generated profits and as profits have declined over the past number of years it's become increasingly difficult to raise even the current levels of regulatory capital.

Most small institutions indicated a strong belief that they will not have very significant access to the external capital markets. So the increase in capital requirements is only one solution to the safety issue and perhaps there are other means of addressing that, both through changes in the supervisory system as well as enabling them to diversify the earnings stream to decrease the level of risk.

Raising capital requirements any further would have a tendency to put U.S. institutions at a substantial competitive disadvantage to other world financial institutions, many of whom now compete for the same customers within our shores.

Senator GORTON. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gorton.

Gentlemen, we appreciate your testimony very much. Mr. McCormick, we certainly will receive in the record that additional information that you wanted to add. Thank you.

[Response to questions posed by committee members from James M. McCormick, Lee E. Gunderson, and Joel P. Friedman follow:]

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WRITTEN RESPONSE TO QUESTIONS BY
THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
BY JAMES M. MCCORMICK
PRESIDENT, FIRST MANHATTAN CONSULTING GROUP
FOLLOWING HIS APPEARANCE BEFORE THE COMMITTEE ON
MAY 22, 1985

Dear Senator Garn and Members of the Committee:

Thank you for the privilege of appearing before the Committee on the important topic of changes in the financial services industry. As a follow-up to my testimony, the Committee posed a number of questions. My thoughts are provided below.*

Question 1:

Would you please explain the capital asset pricing model and how required rates of return are calculated? If returns on equity for banks rose from 9% in 1963 to 12.2% in 1981, how can banks be deteriorating?

Answer 1:

The capital asset pricing model is widely recognized as the best description available of how shares of corporations are priced by the capital markets. Briefly, it states that the total market value of a corporation (i.e., the stock price times the total number of shares outstanding) is equal to the discounted value of all future cash flows which will be available to shareholders.

These cash flows are discounted at a rate which is termed the "required rate of return." The required return for a corporation is made up of the sum of three things:

- ¶ First, the return required to compensate for inflation over the long term

* - Note: These answers were prepared with assistance from Jonathan Moynihan, who heads First Manhattan Consulting Group's Capital Strategies Practice, and other senior members of the firm.

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- ¶ Second, the return the market requires from a riskless instrument, e.g., the 30-year treasury bond. In the last 50 years, this bond has returned, on average, about 1% above the inflation rate
- ¶ Third, the return required to compensate for risk. CAPM measures the risk of a particular stock by its "Beta," which is a quantitative measure of volatility in its stock price relative to other equities.

Over time, an average stock (one with a Beta of 1.0) has been priced in the market to return some 6 to 8% more than the long-term Treasury Bond. Thus, the required return on the average stock is now some 16%. If, over the long term, a stock is expected to achieve a return on equity equal to this required return, then it will have a stock market price that is equal to the book value of investors' equity.*

Thus, the implication of the fact that top 20 bank stock prices have declined, from a market-to-book value of around 1.0 in the early sixties to some 75% of book value currently, is that the market expects these banks to earn a return on equity over the coming years that is below investors' required return. As pointed out in the testimony of May 22, the 15-year secular decline in banks' performance relative to the required return and the market discount from book value suggests that: (i) banks are not making efficient use of equity in their current form as intermediators relative to substitute products (primarily securitized debt) and (ii) banks will be likely to go through a restructuring phase.

* - Of course, there are other factors that influence a bank's stock price - for example, the market's view of the real value of the bank's book investment (e.g., are high loan losses likely to result in book value being eroded?) and the market's view of the bank's positioning in the current wave of mergers and acquisitions. We believe that this last factor accounts for many banks trading at a higher stock price than would normally be the case. This reflects the market's perception that selected banks are candidates for being acquired, and, given that acquisition premiums typically run some 50%-70%, the investors and arbitrageurs are pricing up the stock.

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Over the 1970's the expected long-term rate of inflation rose substantially. The markets, therefore, increased their required return for equities. For each corporation whose required return has risen, one of two things happened:

- ¶ The particular corporation was able to increase its profitability to counteract the effect of the increase in required return. As a result, the stock price of the corporation did not suffer, or
- ¶ The corporation was not able to increase its return on equity, and thus saw its stock price fall, relative to book equity.

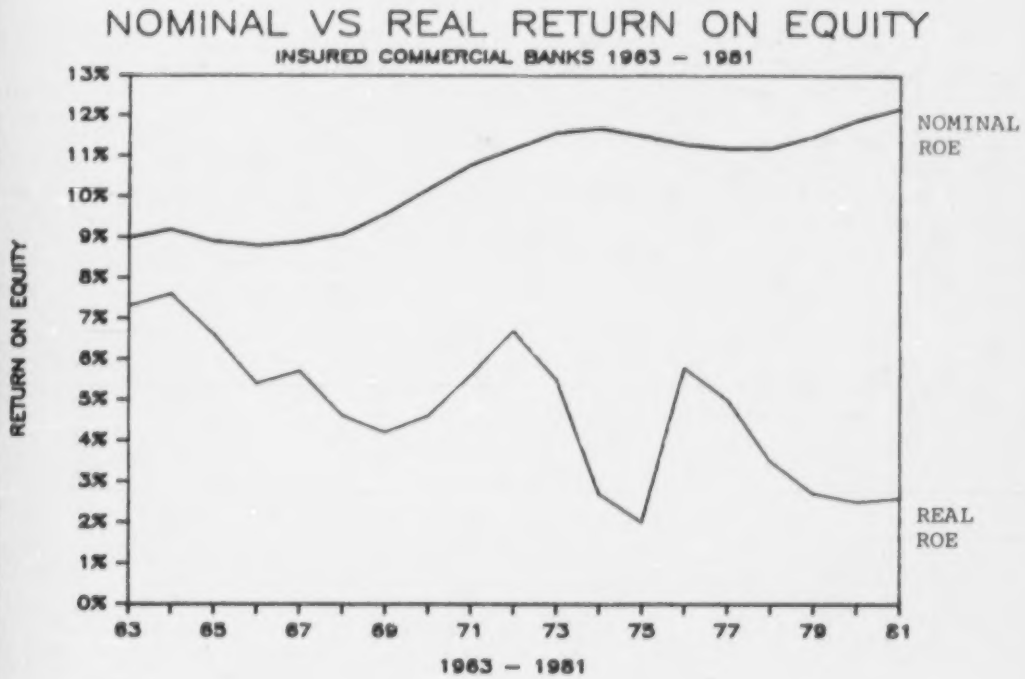
Many industries in America during the 70's and 80's were able to increase their return on equity sufficiently to overcome most of the impact of inflation on their stock price. However, several industries, mostly those with commodity-type products where pricing between competitors was aggressive and demand for the product was purely a function of price, failed to achieve reasonable increases in return on equity, and thus saw substantial problems, industry-wide, with stock price. Of these industries, we believe the Banking Industry was one of the worst affected.

The phenomenon of inflation, and the fact that banks are under pressure from substitute products and thus are in an overcapacity situation, reconciles the apparent paradox stated in the second half of your question:

- ¶ In 1963, inflation was running at about 2%. Banks were, therefore, earning some 7% real return on equity. That is, their 9% nominal return minus inflation of 2%
- ¶ In 1981, banks earned a 12.2% nominal return on equity. However, the market's expectation of long-term inflation was at the time about 12% (judging by the pricing of the 30-year Treasury government bond); thus, banks' real return on equity was approximately 0%.

We illustrate this phenomenon in Exhibit I, where we subtract the rate of inflation each year from banks' return on equity to give the real return. As you have pointed out, the return on equity for banks appears to have risen from 9% to 12%. In reality, when adjusted for inflation, we can see that the return on equity has declined.

Exhibit I



Source: Federal Reserve, National Accounts, FMCG analysis.

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Question 2:

If the increasing obsolescence of the banks' profit formula is the reason that bank stocks are priced so low, how do you explain the surge in bank stock prices in late 1984?

Answer 2:

The trend we have described in bank stock prices is by no means a smooth one. There will be many ups and downs in prices over time. For example, in early 1984, many top 10 banks were being heavily penalized by the market because of their dangerous exposure to potential default by third-world countries, particularly in Latin America.

Toward the end of 1984, this possibility receded somewhat. Furthermore, the market began to reassess future potential levels of inflation, and began to adopt lower discount rates for all capital instruments (in the past year, the yield on the 30-year government bond has dropped by some three percentage points, a dramatic decline). Further, many banks are perceived to be merger candidates.*

As a combination of these three factors, many, but not all, bank stocks rose by up to 30%. However, the increase in stock prices need not be interpreted as increased optimism regarding the long-term potential for future profitability of banks.

* - This is illustrated recently. In the past week or two we have seen substantial rises in stock prices of some regional banks. We believe it is a function of the fact that the environment for regional acquisitions has improved since the Supreme Court's recent decision. Some banks, perceived as potential acquisition targets, are being bought by arbitrageurs who expect to cash in when the acquisition transpires.

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Question 3:

You indicate that a failure to recognize the inefficiencies of banks' current intermediation formula may result in increased lending risks in order to obtain acceptable returns on shareholders' equity. The growth of securitized debt instruments - commercial paper, mortgage-backed securities - cannot be denied. However, is there any evidence of banks increasing lending or interest risk to obtain acceptable returns? What will be signs that this is happening?

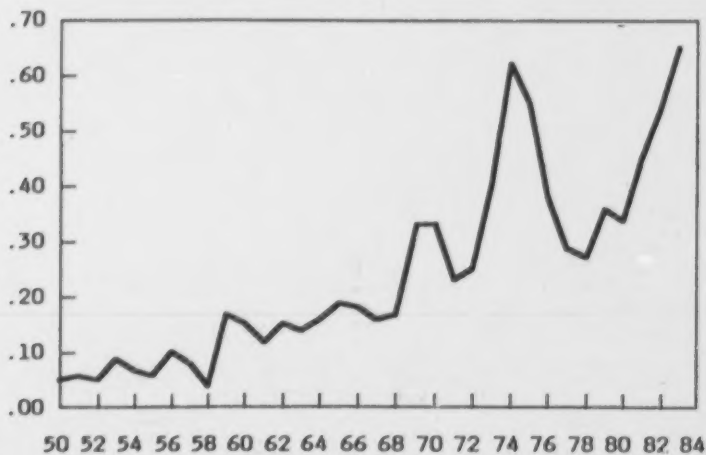
Answer 3:

The evidence that banks have increased the riskiness of their lending is clear and dramatic.

Exhibit II shows the 30-year record of loan loss in the commercial banking sector. The chart speaks for itself. This increase in loan loss is directly influenced by the fact that the less risky corporate borrowers have been increasingly financed by the commercial paper market and by more leveraged foreign banks (who require less equity, and thus require lower spreads, than do domestic banks).

Exhibit II

Net Charge - Offs as a Percent of Total Loans Commercial Banking Sector, 1950 - 1983



Source: DRI

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As the Committee will understand, loan losses in any given year reflect the decisions made several years earlier by the bank in advancing credit to a borrower. Thus, the fascinating question is: What will chargeoffs be over the next few years, as a result of the credit decisions that banks are currently taking?

The evidence on interest rate risk is more difficult to quantify. The entire U.S. Thrift Industry is now severely troubled because of the interest risk taken in the 70's - financing 30-year mortgages with short-term passbook savings. Some people who track the thrift industry note they were pressured to take on interest rate bets - gambles on the future level and shape of the yield curve - because they were boxed in to an outmoded formula for intermediation. This is made clear when one reflects on the fact that they faced major competition from securitized forms of assets (e.g., mortgage-backed securities) and securitized alternatives to deposits (e.g., money market funds).

It is more difficult to quantify the extent of interest rate betting going on in the banking industry, or the degree to which such failures as Continental or SeaFirst were influenced by their interest rate exposure. First Manhattan Consulting is currently conducting research on this question, and will be pleased to share its results with your Committee when the study is accomplished. In any case, the current shape of the yield curve makes this type of risk taking enticing - there is a couple of hundred basis point premium for extending the duration of assets relative to liabilities.

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Question 4a:

For institutions which follow the course of securitizing their balance sheet and become "a more efficient intermediary" - is there any need for deposit insurance? Wouldn't it be contrary to public policy to continue it for those institutions?

Answer 4a:

Without FDIC insurance, it is arguable whether many banks could successfully market deposits to consumers today, given the recent thrift and commercial bank defaults. As long as banks' primary method of intermediation involves assets on their own balance sheet, deposits are a key source of liabilities. Thus, removal of the FDIC today would be a threat to the financial system.

Of course, there are other ways of constructing investments that are palatable to a broad segment of consumers. These could increasingly substitute for deposits. Examples include:

- 1 High-quality debt instruments of a single borrower - here, consumers have shown willingness to invest in high-grade bonds, both corporate and municipal.
- 1 Funds that pool securities to diversify risk - here, large numbers of consumers have invested in pools ranging from money market funds (MMF) to "junk bond" funds.

Of particular interest is the relative acceptance of standard MMFs *vs.* government-backed MMFs. Data provides evidence on investor preferences and risk/reward tradeoffs. Both these types of funds have been offered for some time, with the non-government-backed funds typically offering only 30 bp higher (7.5%) yields. However, as of June 27, 1985, The Wall Street Journal reported that \$140.2 billion of funds is invested in standard MMFs while only \$53.5 billion is invested in the government-backed version. Thus, considerable funds are placed in diversified investments that are not backed by government guarantees.

- 1 Debt guaranteed by private firms - here, the conversion of the transaction to insurance permits specialized firms to participate at very high leverage (e.g., a ratio of assets guaranteed to common equity of the guarantor approaching 80 to 1). There is now an established market for municipal bond insurance, and a

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few insurers are increasingly turning to other forms of guarantees which enhance credit on: residual values of leased equipment, certain forms of credit (e.g., limited/general partner notes), and systems performance (e.g., waste conversion, oil and gas reservoirs).

Given the above, if banks are allowed to move to more securitized forms of intermediation, their balance sheets and deposit levels will shrink, and the amount of FDIC insurance necessary will decline.

Will it remain in the public interest for the government to offer FDIC insurance? We have not had sufficient time to assess this important issue. However, we offer the notion that the shift to securitized investing would not be bad for safety and soundness. Suppose catastrophic economic times hit and 10% of corporations went bankrupt. Virtually all banks that lend to corporations would be insolvent. However, if all this debt was securitized, the value of investors' holdings would decline to, say, 90% of prior value. A loss certainly, but not nearly as disruptive. (For example, normal swings in interest rates shift the value of consumers' aggregate investments in stocks and bonds by $\pm 10\%$.)

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Question 4b:

In your opinion, which loan segments on a bank balance sheet are likely to be securitized over the next 5 years?

Answer 4b:

In terms of which loan categories are likely to be securitized, it is helpful to reflect on the generic attributes of debt that investors will prefer. In general, investors seek:

- ¶ High-quality credits - quality can be related to the investment rating of the borrower or due to the underlying collateral (as is the case with mortgages, auto loans, and increasingly with accounts receivable or lease-backed securities)
- ¶ Credit whose risk quality level can be efficiently determined - here, rating agencies play a role as well as financial analysis of public information. For example, in the case of mortgage-backed securities, the originator must make sure the underlying credits comply with certain standards
- ¶ Liquidity - that is, the ability to sell the investment to someone else in an efficient market
- ¶ Credits of known maturity - this enables investors to match the maturity of their liabilities to their assets. Prepayment options on mortgages, for example, presented a challenge in this area
- ¶ Fixed rate (or predictable rate) - here, most large institutional investors are interested in longer maturity securities of fixed rate. For floating rate issues, investors prefer that rates are tied to the major categories of money market debt, e.g., governments, CDs, etc.
- ¶ Economic lot size - for most securities aimed at institutional investors, this means \$25 million plus in terms of the size of the issue. Smaller lot sizes typically aren't economic because of the overhead associated with origination, structuring, and distribution
- ¶ Ease of diversifiability - for consumers looking to buy in small lots, mutual funds can provide the ability to diversify.

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Not all these factors must exist to securitize debt. In addition, investors will make tradeoffs if returns warrant. For example, insurance companies will invest in private placements with low liquidity if the returns are sufficient.

Thus, in many cases, the list of preferences above poses a challenge, not a roadblock, to securitizing loans. We anticipate that innovative financiers will be looking for ways to securitize virtually all major categories of debt. They will have most difficulty with corporate debt where the amount of the loan varies frequently - e.g., in the case of the cyclical part of working capital loans or M&A financing. There will also be significant hurdles to cross in the case of middle-market commercial lending due to lack of standards - e.g., homogenous credit quality, standard terms and agreements, standard pricing. Further, credit card outstandings will present challenges. However, we understand that at least two major investment banks are actively working on solutions currently.

In summary, we at First Manhattan Consulting try to have a pragmatic perspective in terms of how fast debt will transform from loans to security form, combined with a healthy respect for the innovativeness of financiers. Perhaps a few quotes from national publications will provide a perspective on how others feel.

- ¶ "The mind boggles at the number of things you can do (with securitized assets)."

- M. William Benedetto
Dean Witter Reynolds

- ¶ "It seems to me some clever Wall Street type will eventually figure out a way to package damn near everything you can come up with. And there's a huge market out there for it."

- Curt Bradbury
Investment Banker

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- ¶ "This is one of the most important developments of the 1980s. There's no doubt about it. A tremendous number of companies are going to have to look at this financing alternative."

"Companies and financial institutions are finding that by packaging and selling loans, receivables and other financial assets via pass-throughs or participations or by using them as collateral to back more conventional securities issues, they gain access to the optimal market at the best rates going. In the bargain, they have a new tool for managing their balance sheets and promoting liquidity."

- Anthony Dub
First Boston

- ¶ "A major amount" of new deals will be done over the next six months."

- Gordon Pattee
Merrill Lynch

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Question 5:

In your opinion, which is riskier - making a commercial loan or underwriting a security? Are different skills required? What are success criteria for being a successful underwriter?

Answer 5:

The risks involved in making commercial loans *versus* underwriting securities are of a different nature.

Making a commercial loan involves what is known as "term risk." That is, the risk involved in extending credit over the period of the loan, with the risk that the money lent will not be returned. Also, if the loan is funded by liabilities of a different maturity there is "mismatch risk" as well.

Underwriting a security involves "pricing risk." That is, the risk that the market will not accept the terms under which the security is offered, so that the underwriting house, which typically only has to hold the security on its books for a matter of a few days, is eventually forced to sell the security into the market at a discount below the terms agreed with the issuer.

Thus the success criteria for an underwriter are to understand the market's pricing mechanisms, and to have an efficient distribution setup which will place the security as swiftly as possible into the market before there is any change in the pricing climate.

In terms of riskiness, both roles obviously offer the potential for loss. However, a few factors suggest the bank role is an increasingly difficult one:

- ¶ First, bank loan loss from commercial and industrial lending has increased, as shown above
- ¶ Second, as better quality credits are increasingly securitized, banks will be left with a portfolio that is riskier
- ¶ Finally, due to forces on bank profitability described in the testimony, some banks may feel increasing pressure to take on higher risks in order to have a chance to achieve the required return.

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Question 6:

If banks no longer hold debt - who will? Who is more capable of making credit decisions and holding debt than banks? Won't these entities need a risk capital cushion as well as liquidity? In the aggregate, would less capital really be required?

Answer 6:

As banks are disintermediated by securities, the investor in the new security will be the person who previously held CDs. That is, with the bank no longer existing as an intermediary in the sense of holding liabilities (i.e., CD's) and assets (i.e., loans) on its balance sheet, the debt flows through to the ultimate holder.

We believe that these holders will not require the same risk capital cushion for reasons described in answer 4a. Basically, less intermediation capital will be required, both because the Law of Large Numbers can diversify credit more efficiently than an individual bank can, and because the holders of the new securities - consumers, corporations, pension funds, and so forth - will be purchasing assets with as much as 100% capital, relative to the 6% capital that the average bank has.

Of course, banks are quite capable of making credit decisions, and this capability will still be important. In fact, banks will be strong competitors in originating debt.

Thus, banks could play a role in identifying relative credit risk among borrowers, and then package that debt and sell it as a security to the capital markets.

Incidentally, as capital in the banking industry shrinks, it will of necessity have to be redeployed into other industries in America, thus fueling further economic growth and vindicating the capitalist process.

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Question 7:

Would you briefly describe the other possible bank transformations such as "operating and information service bank," "retailer," and "loan servicer" in writing?

Answer 7:

Banks can evolve to and/or expand various roles that provide value and do not require them to compete at a disadvantage; for example:

- ¶ In operating and information services - banks have experience in providing corporate payment services (e.g., cash management and securities processing), corporate information services (e.g., through terminals that provide data on transactions, quotations, etc.), correspondent services (e.g., ATM/POS switching, data processing, and payment clearing), and consumer services (e.g., payments).

These services are not necessarily balance sheet intensive, and thus banks do not face intrinsic disadvantages when competing with nonbanks. However, these services are becoming more competitive and less fragmented in terms of market share. Thus, only the strong players that treat these services as a business are likely to reap significant returns

- ¶ In retailing - here, banks with strong distribution will be capable players in selling and servicing an increasingly diverse set of financial services. Deposits could stand side by side with, say, mutual fund investments. Thus, banks with superior retailing skills and relatively low-cost distribution will succeed, even if the contribution from liability and asset spreads declines in proportion to other sources of revenue
- ¶ In loan servicing - here, as more debt is securitized, opportunities will exist that are analogous to mortgage servicing. For example, if auto loans are increasingly packaged and sold as securities, some banks will likely choose only to originate loans, while others could specialize in servicing.

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Question 8:

What transformations do you see as necessary for the community bank?

Answer 8:

The community bank plays an important role in the banking needs of the nation. Its physical locations are an important convenience to the community, and in all probability the community bank will always remain an appropriate institution for lending to small businesses in that community, given that local knowledge is crucial to understanding credit risk in these small companies.

However, it must be recognized also that the community bank of today may find itself increasingly inefficient. Since community banks often have high capitalization, they are particularly susceptible to shrinking margins on the deposit side as more consumers seek out the higher rates that diversified pools of securities may provide. Thus, even the community bank may find it advantageous to transform to a structure that is less equity intensive. The community banks that survive and prosper in such an environment will be those who recognize where they have real competitive advantages, typically in retail distribution or debt origination.

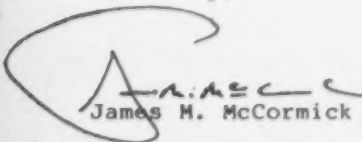
* * *

We at First Manhattan Consulting Group have greatly appreciated the opportunity to present our future prognostications for the banking industry to such a distinguished and important audience.

It is gratifying that your Committee is treating these important and far-reaching issues with such concern. It is our hope that the Committee will be able to see its way through to promoting legislation which supports constructive development of these long-term trends, rather than allowing them to develop into an unfortunate period of turmoil and discontinuity.

If we can be of further assistance to the Committee, please let us know.

Sincerely,


James M. McCormick

Response to Questions from
Senator Garn by Lee Gunderson

QUESTION 1. Most analysts believe that low cost deposits are becoming history. Do you agree? If this trend is combined with higher capital ratios and the securitization of commercial and consumer loans will banking become more risky? If so, what can or should we do to stabilize the banking industry?

ANSWER 1. Deregulation of deposit interest ceilings has phased out a large portion of low cost deposits for banks. As of December 31, 1983, 70 percent of all deposits were receiving market rates, as compared with 46% in 1978. This trend could expand even more significantly if the payment of interest on commercial checking accounts is authorized.

Payment of market rate interest on deposits has created some pressure on margins for banks. However, the advantage of being able to compete for deposits with other forms of financial institutions overrides the cost of the funds. In my opinion, deposit interest rate deregulation has prevented liquidity problems for banks.

It is difficult to assess the risk factor in a combination of a continuation of the trend of deregulated deposits, along with higher capital ratios and expanding off balance sheet activity. The question asked about the impact of securitization of commercial and consumer loans. Off balance sheet activity extends far beyond the one area of securitization of loans. It also includes activities such as standby letters of credit and interest rate swaps. Higher capital ratio requirements create an incentive for off balance sheet activity. The potential for risk is certainly inherent in

the expanded movement to off balance sheet transactions. At the same time, it would be counterproductive to over react to this potential and create an environment that would prevent banks from engaging in business ventures that are appropriate for them.

It seems to me that there are realistic methods to address and control the risk factors in the areas of further deregulation, capital requirements and off balance sheet transactions.

Deregulation of deposit interest ceilings can be managed by appropriate asset/liability management, as well as proper pricing of loans and deposit accounts. Regulatory review, both on site and through reporting requirements, will provide adequate evaluation of the banks ability manage this element of their operations.

Further increase in capital ratios will do little to stabilize risk in banking. The current regulations provide the regulators with enough flexibility to require capital ratios that are commensurate with the financial condition of the bank. Increases, over and above current capital ratios, could conceivably create greater risk by adding an additional inducement for expansion of off balance sheet activities.

The increase in off balance sheet lending and fiduciary

operations has raised areas of concern by the regulators. This expansion has primarily been with banks of \$5 billion in assets, or greater. The regulatory process could have the capability of properly monitoring the risk factor in these areas by requiring strong internal controls and policies from banks. Examiners could then evaluate the controls and procedures in the banks, in a manner similar to recent policies adopted on "daylight overdrafts". This approach would provide adequate controls and, at the same time, allow banks to meet the needs of the financial markets and effectively function as financial intermediaries.

The ultimate solution to minimizing risk, is to pass legislation authorizing banks to expand their products and services. This would provide opportunities for banks to generate additional sources of income to cover the costs of the deregulation of deposits. It would also increase equity capital through greater retained earnings.

QUESTION 2. Do you believe the banking, insurance, and securities industries are becoming one financial service industry? Should Congress authorize joint ventures among/between them? If so, what kind of joint ventures?

ANSWER 2. While I believe that the lines of distinction between banking, insurance and securities firms will eventually become somewhat blurred, I doubt if they will ever become one financial service industry, in the strict sense of the phrase. Unfortunately, for banking, the current blurring of lines of distinction has been rather one sided with insurance and securities firms providing banking and bank-like services and with few opportunities for banks to provide insurance and securities products, because of the limitations of current laws.

Rather than authorize joint ventures between these three financial services businesses, Congress should pass legislation allowing banks to enter the securities and insurance business. This would provide equity for banks in the competitive environment. It would also enable the banking, insurance and securities industries to develop joint ventures, where feasible, based on market place needs. This approach would have distinct advantages over attempting to legislate which types of joint ventures would be appropriate. Authorization of joint ventures would only be a continuation of the piece meal approach to the financial services issue and would probably postpone action on the more comprehensive issues.

QUESTION 3. What concentrations limits would you impose on the banking industry?

ANSWER 3. It is difficult to assess, at this point in time, if concentration limits should be imposed on the banking industry, as interstate banking becomes a reality. I would not want to see the United States have a banking system comparable to those in Canada or the United Kingdom. I firmly believe that there is a need for well run community banks and mid-size banks in our nation. I also recognize that there are forces at work in the nation's financial system that make interstate banking both desirable and inevitable.

Anti-trust laws, along with limited capital, will certainly provide inhibitions on the ability of a large money center bank to dominate the U.S. banking market through aggressive acquisitions. Regional interstate banking, during the formative period of interstate banking, will allow banks in the various regions to become stronger and better positioned, prior to full interstate banking.

I have a natural aversion to establishing concentration limits, through legislation, at this early state of the game. I also have confidence in the ability of the thousands of community and mid-sized banks in the nation, to continue to be survivors in an interstate banking environment. Concentration limits, established at this early stage of interstate banking, can only be based upon speculation as to what would be appropriate.

My personal feeling is that much of the current speculation is unduly negative and does not include proper recognition of the strengths and resourcefulness of the smaller banks in the country.

Lacking realistic data, forecasting the potential concentration that could be created by interstate banking, I believe that enactment of concentration limits should be deferred. The regional approach to interstate banking will provide the opportunity to develop information regarding potential concentration in the banking system. Decisions, regarding concentration limits, could then be made, based on sound data, rather than on speculation.

QUESTION 4. In your opinion, are our regulatory agencies understaffed? Why do you say this? How would paying career examiners more help?

ANSWER 4. Our regulatory agencies are definitely understaffed. The pressures of regulating closed banks and problem banks, along with normal examinations, has spread the ranks of the regulatory agencies far too thin. Compounding this problem is the loss of quality personnel to banks and other institutions, because of the inability of the regulatory agency to be competitive in the areas of compensation and career paths. As a result of this, the agency ends up with a preponderance of younger personnel who lack the experience to adequately understand the various elements of a rapidly changing banking environment. This problem will become even more pronounced as further deregulation of banking occurs.

The entire compensation system for the regulatory agencies should be reviewed at all levels of the agency. If the agencies are not able to compete, in the job market, there will be further deterioration in their ability to attract and retain quality people. This will be true at both the examiner level and at the senior staff level.

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June 19, 1985

Senator Jake Garn
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Garn:

I am pleased to respond to your questions regarding my testimony before the Committee on May 22, 1985. We have appreciated the opportunity to participate in the Committee's assessment of changes facing the financial services industry.

1. You indicated that all three industries have ended up with relatively common needs -- particularly with regard to broader product lines and lower distribution costs. Some have described the "distribution revolution" as an effort to put more products on their truck while maintaining the quality of each product -- thereby increasing consumer convenience and lowering unit delivery cost of each item. Would you agree?

As your question notes, the banking, securities, and life insurance industries are generally seeking to broaden their product lines and to increase the effectiveness of their distribution channels. To a great extent, these efforts will both increase customer choice while at the same time lowering distribution cost. There are limitations, however, in drawing generalized conclusions from this broad statement. Product diversification and lower distribution costs do not automatically go hand in hand when considering individual financial service providers. For example, some product diversification has focused on the so-called upscale consumer market, where the goal is to provide high quality, differentiated service at a premium price. In such cases, lowering the distribution cost is not a major objective of the provider. In fact, examples such as the "personal banker" approach adopted by many institutions may increase distribution costs -- which may ultimately be recovered through higher prices which result from responding more directly to the needs of specific buyer segments. Other institutions may lower the distribution costs by simplifying product lines, concentrating on high volume, lower cost, standardized services. Institutions will select from a wide array of product, distribution, and segmentation strategies which may increase revenue, lower cost, or both.

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Sentor Jake Garn

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2. In the opinion of the Delphi participants, is the continued blurring of lines between banking, insurance, and securities inevitable? Why?

There is no question that there will be continued movement by banks, securities firms, and life insurers to offer products traditionally offered by the other industry segments. The reasons for this are many, and were outlined in my testimony:

- . Changing customer needs
- . Changing economics which make traditional products (such as whole life insurance) less desirable and profitable
- . Better utilization of distribution channels
- . Blurring of product distinctions (for example, is the Merrill Lynch Cash Management Account a deposit account, loan, or investment account? Is an IRA a banking, brokerage, or insurance product?)

Despite this trend, it should be noted that the panelists responding to all of our industry studies agreed that the vast majority of providers within each industry are likely to retain their traditional identity as a bank, broker, or insurance company. Banks will continue to primarily focus on deposit and lending services, insurance companies will provide protection, and securities firms will offer investment vehicles for the creation of wealth. Few anticipate the homogenization of the financial service industry. This is consistent with consumer resistance to the notion of the financial supermarket, offering one-stop financial shopping.

3. Should Congress authorize joint ventures among and between participants in the banking, insurance, and securities industries? If so, what types of joint ventures?

Joint ventures already exist in the financial services industry. In recent years, we have seen Bank of America form an alliance with Capital Holding to sell insurance through bank branches. First Interstate Bank has formed a comparable relationship with Safeco Insurance. A number of banks have contracted with Dreyfus to provide mutual fund services and other investment vehicles to their customers. Securities firms are routinely distributing annuity products developed by insurance companies. The same firms also in many cases sell certificates of deposit. Brokers are also buying, "securitizing," and distributing pools of mortgages. Few of these involve legal joint venture arrangements. Most are contractual arrangements between various providers to broaden the product offering of one participant and create new distribution channels for the other. Some of these relationships have been established due to regulatory restrictions

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governing permissible activities of a given financial services provider. In other cases, these relationships represent a logical alliance that might take place regardless of legislative authority. Such ventures represent an opportunity for institutions to share expertise, investment risk, and customer bases.

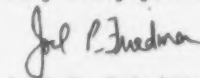
With respect to Congressional authorization of joint ventures, it is unclear as to what level of authorization is required. This question should perhaps be addressed in the broader context of permissible business activities which may be directly -- or indirectly -- offered by financial services providers.

4. You cite a Business Week survey where approximately 1/3 of respondents preferred to obtain financial services at a single institution and another 1/3 which may be swayed. This is very significant. Do you know whether this survey can be projected nationwide with a reasonable degree of confidence? Are you aware of any similar surveys?

My interpretation of the research is that the majority of respondents are not strongly interested in one-stop financial shopping, preferring to maintain multiple financial service relationships based on the ability of given providers to offer either better or lower cost services. It is my understanding that the research was performed for Business Week by McGraw-Hill Research, and surveyed 2,000 Business Week subscribers. I cited the study in my testimony because it was current and because the demographics of Business Week subscribers are likely to overlap with the more sophisticated users of financial services. I do not know enough of the details of the research to determine whether the findings can be projected to the nation as a whole, although I think this would be unlikely. I suspect that the demographics of Business Week subscribers are not representative of the nationwide population. For better analysis, you may wish to contact McGraw-Hill Research directly. Unfortunately, I am not aware of other comprehensive surveys of consumer attitudes regarding financial supermarkets or one-stop financial shopping.

I hope these answers have responded completely to your questions. If we can be of any further assistance, I hope that you, the Committee members and staff will feel free to contact me at (415) 546-8424.

Very truly yours,



Joel P. Friedman

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Mr. CHAIRMAN. Next I'd like to invite to the witness table Mr. Larry Connell and Mr. Lawrence Evans.

Senator GORTON. Mr. Chairman, I'd like to welcome my constituent, Larry Connell, here and tell you that Mr. Connell was a very innovative banker who has surmounted some significant difficulties in his own institution in a both constructive and commendable fashion, and at the same time to warn him that after he is finished with his opening statement that I want his comments on Mr. McCormick's ideas as well.

The CHAIRMAN. Mr. Connell, please proceed.

**STATEMENT OF LAWRENCE CONNELL, PRESIDENT, WASHINGTON
MUTUAL SAVINGS BANK, SEATTLE, WA**

Mr. CONNELL. Thank you, Mr. Chairman, and thank you, Senator. My name is Lawrence Connell and I'm president of Washington Mutual Savings Bank. Washington Mutual is an FDIC-insured State-chartered savings bank based in Seattle with about \$4 million in assets and under State law has ownership of a full line brokerage firm with some six mutual funds, a small life insurance underwriter, and a full line insurance agency.

I appreciate the opportunity to testify before the committee and I would ask that my formal remarks be included for the record and I will try to abbreviate them in the interest of time.

I wish to commend you, Mr. Chairman, for your leadership with respect to S. 2851 and thank Senator Gorton for his leadership in this area.

FLEXIBILITY TO ADAPT

I have been asked to focus on the question of whether greater legal flexibility increases or diminishes the risk of particular institutions and the system as a whole.

Given the air of crisis here locally in the thrift industry I'm afraid my answer might not be altogether popular. But as one who spent some 27 years in the industry, both as a regulator and as a practicing banker, I am absolutely convinced that the flexibility to adapt is critical to the health and stability of specific institutions and the system as a whole.

As the previous witnesses have indicated, powerful external forces have reshaped this financial services industry. It's now more complex, more difficult, and generally more competitive. Therefore, depository institutions must have the legal flexibility to adapt.

But I'd like to make another point, and that is at the same time they must operate according to traditional and fundamental fiduciary standards and those who do not conduct their business with fiduciary care should be disciplined promptly and Government must ensure that these standards are upheld through ongoing, thorough supervision, statutes, and regulations should provide a prudential framework for the implementation of this broad array of power and the means of proper discipline.

I recognize that in this environment there is a strong temptation to reimpose old restrictions or limitations or even adopt new restrictions in the hope of shoring up the legal framework that was erected some 50 years ago to separate banking, insurance, securi-

ties, and real estate activities, but closing these so-called loopholes and imposing restrictions really is not a long-lasting solution. It's only a quick, short-term fix.

In fact, that would represent a dangerous step backward because it fails to take account of the fundamental forces that have changed this industry and the financial system and the economy as a whole and I believe it would tend to increase the likelihood that insured banks and thrifts would be relatively less competitive and less stable in the years to come.

Of course, these changes are the high-interest rates, the volatile interest rates, technology, consumer preferences, and that type of thing.

This led to the deregulation of 1982. It began back in the late 1970's. It's a movement that is going to continue. It's natural and evolutionary.

Although the thrift industry probably has been more profoundly affected by these forces than any other segment of the financial industry, until the late 1970's thrifts enjoyed a relatively simple, protected, and restricted life and lived in an undemanding world. At the same time, when these interest rates moved to historic highs and stayed there, the industry was devastated and, of course, we followed with this interest rate deregulation.

Following the interest and deposit rate deregulation, Congress, the Bank Board and a number of States adopted policies designed to provide thrifts with additional flexibility to pursue a business strategy which was really appropriate with this changing economic circumstance and for well-run and responsible thrifts Garn-St Germain provided a key to a long-term survival. It was and still is the right policy.

But it's plain that some read the message of deregulation to mean no restriction and, as a result, a few high flyers abused the deposit insurance system and their fiduciary responsibilities by overcommitting their company's assets in speculative ventures, including real estate development and common stocks.

Despite the diligent efforts of what I call the seriously understaffed Bank Board and other regulatory agencies, irresponsible and sometimes fraudulent activities caused a number of savings and loan failures and placed some severe pressure on the Federal Savings and Loan Insurance Fund.

But the problem was not deregulation or expanded powers but rather the failure of management of particular institutions to exercise their powers according to traditional fiduciary principles and that's one point I want to make continually.

NEW ENGLAND SAVINGS BANKS

I'd like to contrast the more troubled savings and loan industry with the New England savings banks. As my statement indicates, they have a net worth and a profit rate double that for the federally insured savings and loans, and that's a very clear, empirical message. Because these savings banks have long had legal flexibility to respond to the markets in their States, they have been able to offer a much broader array of consumer lending and commercial lending activities. They have been able to invest in equity and cor-

porate debt securities for decades as well as real estate. But most important I think is that they have done so with fiduciary care and this I say not as an academic but having spent some 10 years traveling the New England countryside and being bank commissioner in Connecticut where I had savings banks, savings and loans, as well as commercial banks to deal with.

It was clear that there are standards that are necessary for safe and sound banking, but as a person who worked in the other side, having had to live through the difficulties of the thrifts, I think I've seen what it takes to have to continue to exist and survive in a difficult economic environment.

What I'd like to do is focus on a few of the specifics in bills that are presented before this committee, specifically S. 2851, S. 716, and S. 759.

First of all, I would like to say we should build upon the Garn-St Germain Act. By granting regulators new and flexible authority, providing thrift institutions enhanced operational flexibility and a greater diversity of assets, I think Garn-St Germain was a good step forward. I think new legislation should grant new powers and flexibility to bank holding companies, including at a minimum the powers in S. 2851.

Second, I don't believe we should expand or extend the coverage of Glass-Steagall to thrifts and other bank-type institutions. That's because these activities present no credit or asset risks, particularly in the sales brokerage, mutual fund, and distribution of securities. Those are agency-type activities and they really don't involve any type of credit risk.

Underwriting does entail risk, but it can be controlled. It can be controlled by aggregate limitations on exposure in underwriting of common stocks or aggregate limitations such as the lending limit to any one issuer.

But as a practical matter, the way investment banking is carried out today, the underwriters minimize their actual credit risks.

Also, I know of no abuses now by those who are involved in banking-type institutions that have affiliates in the securities business and we have probably the most pervasive, extensive, credible securities regulation system in the world. It has been very successful in protecting investors and I think it will continue to do so.

Last, we all know that the securities industry has used Glass-Steagall to keep out potentially significant sources of competition and, as the testimony from Mr. Preston of Morgan indicated, there's been a dramatic increase in concentration in the investment banking industry and I really believe in terms of analyzing concentration in the financial industry that his testimony should be given very, very careful consideration.

We should also not impose a new thriftiness test. That's because basically it could very well increase risks to the deposit insurance funds. A number of the bills have proposed an even stricter test than exists now.

Savings banks have been real thrifts since 1816. That's over 150 years. They promote savings and preserve family credit needs and the proposed thrift test, even with a 10-year phase-in, would require them to concentrate their portfolio lending strictly in mortgages for the next 10 years. That isn't necessarily sound because

it's putting all your eggs in one basket. It's a concentration of investments again, even with adjustable rate mortgages. I think the key thing is that the institutions would be required to invest all their assets or more of their assets in what I call a cyclical industry with its ups and downs.

I believe we should preserve State powers. The ability of a State to authorize its institutions to experiment and be innovative is a strength in our Federal system and we should focus on the strengths in the Federal system, not just the weaknesses.

As I indicated earlier, the evolution of these broad powers produced net worth and profits double those of other thrifts.

A few States have taken action that probably, in retrospect, was not the wisest and, of course, the prime examples are California and South Dakota. In the California situation, S&L's are allowed to invest all of their assets in any activity and to me that is a violation of basic standards of diversification and don't contain the restraint of the prudent person-type standard. That was one missing ingredient.

In terms of the South Dakota legislation, I guess my concern is that the banks are allowed to offer the particular insurance service everywhere but the State of South Dakota, and that's kind of a perversion. If they are able to also offer it in their State, then I would say that's a proper role of a State law, but otherwise it becomes neowildcat banking.

But I don't believe there's any need to confine institutions within a State's borders in terms of powers because we now have this movement toward regional interstate banking and it would just cause an awful lot of complication and be unnecessary as the regional compacts come into place.

Most of all, I believe that Congress should ensure that the regulatory agencies have all the resources and powers necessary to do their job effectively and in that regard I very strongly support the provisions of S. 759 which allow the Bank Board greater power to reach any person or entity that would affect the solvency, soundness, or prudent conduct of an insured institution. This is the type of regulatory powers they really need.

NUMBER OF SUPERVISORY PERSONNEL

An even greater and more pressing need is a substantial increase in the number of supervisory personnel because you really need people to do this job, and the artificial ceilings put on by the Office of Management and Budget really are as Hobart Rowan said in that column which I agree with that part of the column anyway, penny wise and pound foolish.

In conclusion, the challenges facing bank management and regulators and the State and Federal regulators is managing change and managing the change in the light of vast changes being brought about by the economy, technology and the historically high interest rates, as well as competition and consumer preferences.

Managing change in deposit-taking institutions involves the exercise of fiduciary care in the interest of the depositors who entrust their savings and temporary funds to that institution.

Regulation has proved necessary to balance the sometimes conflicting demands of business entrepreneurship in a competitive world and those fiduciary responsibilities.

Good Government would suggest that regulation not interfere with the basic operation of the marketplace, and I guess I learned this some 20 years ago when I worked for Jim Saxon here in Washington as a young law school student, but I also learned that the role of regulation is to establish the minimum standard of conduct for the prudent operation of a bank or any other financial institution and then when the institution breaches that standard of conduct you have got negligence per se and liability. But the regulations should not interfere with the marketplace.

Many of the arguments presented to the committee in opposition to greater flexibility of the banking institutions represent the request for regulatory protection from competition. In the long run, these protections will not enhance safety and soundness, but increase risk.

On the other hand, the Federal Deposit Insurance Funds are not a license to speculate with depositors' money and those who are not acting with fiduciary care should receive the harshest treatment.

The committee and Congress should act to permit greater flexibility in bank and thrift operating powers in order to accommodate these fundamental changes. At the same time, it is imperative that the regulatory agencies be provided the necessary tools and financial resources to ensure that institutions exercising their powers do so according to high fiduciary standards. I don't know of any banking institution that would complain about paying for good supervision. To ensure a strong financial system and economy in the future, Federal policy should provide greater operating freedom coupled with fiduciary responsibilities for institutions and a modern regulatory system.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

[The complete prepared statement follows:]

Statement of
Lawrence Connell, President
Washington Mutual Savings Bank
Seattle, Washington

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate
May 22, 1985

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to testify before the Committee concerning a broad range of matters of critical concern to the thrift and banking industries, to the financial system, and to the economy as a whole. I congratulate you, Mr. Chairman, on the leadership that you exhibited with respect to S. 2851. I also want to take this opportunity to thank Senator Gorton from my own State of Washington for his leadership. I assume that S. 2851 provides the starting point for the legislative process in the 99th Congress. It is also clear that a number of other important issues including deposit insurance reform, the financial condition of the FSLIC and the thrift industry, and enhancement of the supervisory capabilities of the regulatory authorities, will be considered as a part of this process. Many of these issues have been dealt with in proposals already submitted by the Federal Reserve Board, the Federal Deposit Insurance Corporation ("FDIC"), and the Federal Home Loan Bank Board ("Bank Board").

In discussion with Committee staff, I have been asked to focus on the subject of flexibility -- in particular the question of whether greater legal flexibility increases or diminishes risk to particular institutions and to the system as a whole. Legal flexibility is an institution's opportunity under the law to offer the widest possible range of financial products and services and to develop business strategies based upon market forces, not legal constraints. I am pleased to testify today because I believe that the answer to that question provides the key to the shape of the legal and regulatory framework that will govern depository institutions in the decades to come.

Before addressing some of the proposals before you, I would like to discuss my understanding of the problems we face. My message may not be a popular one because I perceive the mood of Congress to be quite different from what it was in 1980 and 1982 when major deregulatory banking legislation was enacted. In recent weeks, the crisis of state-chartered and state or privately insured institutions in Ohio and now Maryland has been on center stage and appears to have made many in Congress fearful about the condition of our banking system and concerned about the role of state institutions within that system. At the same time, the Chairman of the Bank Board again has reminded you of the ongoing crisis in the savings and loan industry and the potential threat to the Federal Savings and

Loan Insurance Corporation ("FSLIC") fund. In the last two years, bank failures have been running at record post-Depression levels, and major banking organizations have experienced difficulties that could have become cataclysmic failures but for extraordinary governmental intervention. It is also clear that matters are not helped by the fact that interest groups continue to press their own special legislative interests.

In this environment, there is a strong temptation to reimpose old restrictions and rigidities, or even adopt new restrictions, in the belief that legal rules can contain the powerful forces of change that in recent years have seriously eroded the legal framework erected decades ago to govern financial institutions. But closing "loopholes" and imposing restrictions is not a lasting solution, only a quick, short-term fix. Such legislation would represent a potentially dangerous step backwards.

The proper policy for this period may be simply stated: Because powerful forces have reshaped -- and are continuing to reshape -- the financial services industry and are making the world more complex, more difficult, and more competitive, depository institutions must have legal flexibility to adapt; at the same time, they must operate according to traditional and fundamental fiduciary standards

that protect depositors and the depository system and that maintain safety and soundness. Those who do not conduct their business with fiduciary care should be disciplined promptly and severely. The basic role of government is to ensure that these standards are upheld through ongoing, thorough supervision. Statutes and regulations should provide a prudential framework for the implementation of a broad array of powers and the means for proper discipline.

This message is based upon the hard reality that fundamental forces of change have been shaping -- and will continue to shape -- the financial services industries in this country. These forces by now are familiar to us all. They include: a difficult economy characterized by high and volatile interest rates, changing consumer preferences, accelerating technological innovation, a vigorous spirit of entrepreneurship, and a deregulatory philosophy. Technology especially is propelling us into the future. It already permits electronic funds to move instantly without regard for legal or geographic boundaries. It permits nonbanking organizations to offer bank-like products on a mass basis. These forces became evident during the late 1970's, have been gaining momentum during the last five years, and will probably continue to gather force. They have helped to merge what used to be a number of relatively separate financial activities -- commercial banks, thrifts, insurance companies, and securities firms -- into a financial services industry.

These forces have the power and independent energy of forces of nature. They make today's environment hostile and difficult. They are more radical than we can imagine and are fundamentally uncontrollable. Because they represent a natural evolutionary process that cannot be stopped, survival requires the ability to adapt and the flexibility to change. Government's role should be to provide that flexibility and to temper and shape change as best it can. The combined powers of government cannot stop a mighty river from changing its course. Government can only attempt to map its likely new direction and begin to adapt to it, even while providing emergency aid to those displaced by it.

As suggested above, three principles should govern policy in this difficult time.

1. The Flexibility To Adapt Is Essential. Depository institutions must have the maximum legal flexibility to respond to this change, to develop and modify business strategies that are responsive to the marketplace and to the customer. I am absolutely convinced that flexibility -- with respect to the setting of price, to the design of products, to the extent of expansion -- is essential to the safe and sound conduct of the thrift or banking business. Flexibility to organize and conduct business almost by definition diminishes risk. It is this principle that underlay the decision of Congress in 1980

to phase out interest rate controls. And it is the principle which provided the foundation for the Garn-St Germain Act. This principle should be reaffirmed, not diluted or abandoned.

In the best of all worlds, that flexibility would permit an organization to offer its customers banking, trust, insurance, and securities services and products. This flexibility permits it to achieve greater efficiencies, for example, by using existing systems of branches and offices to offer the consumer both the traditional savings and mortgage products, as well as transactions services, consumer credit and securities, trust and insurance products. Some organizations -- including especially some savings and loan holding companies and nonbanking organizations that own "nonbank banks" -- now possess that flexibility.

Flexibility is necessary for both individual institutions and the system as a whole. As it evolves, the system must be able to adapt to changes in interest rate patterns, consumer preferences, and technology, as well as to new competitors and new products. Restrictions make the system rigid, and rigidity causes fragility.

We recognize that there are profound policy issues concerning the types of activities that may be linked to an insured bank or thrift, and in particular the type of assets

and activities that should be supported by insured deposits. We believe that resolution of these questions should be a national priority. While this policy debate goes on, however, our strong bias is for permitting those organizations that have that flexibility under present law to continue to operate without arbitrary restrictions. Until a consensus emerges concerning the future shape of the financial services industry, existing organizations should be permitted their present legal flexibility.

2. Flexibility Must Be Combined With Fiduciary Responsibilities. There is an important and necessary corollary to this principle -- one that has been often ignored. Depositors and the government that insures deposits should expect depository institutions to act according to fiduciary standards.

Maintenance of these standards will ensure that flexibility is not a code word for laxity and license. Fiduciary standards mean that an institution will be sound because it will be run with competence, integrity, prudence, and care. Those who breach these standards should be swiftly disciplined. Bank management has traditionally been held to those standards. For many savings banks, such responsibilities are a matter of statute. We believe they are fundamental and should be upheld by depository institution officials as a

matter of personal responsibility, as well as legal obligation. It means that if a depository organization has broad powers, it will invest its assets prudently, diversify and limit its risk exposures. These qualities should be reflected on its balance sheet and income statement and can be tested during the examination process.

3. Government Must Supervise, Not Constrain. My final principle concerns the role of government, and it is also corollary to the first two. In the face of these inexorable forces of change, government must emphasize supervision. Government should establish minimum standards of conduct that reflect fundamental fiduciary principles and then see that they are upheld. It should adopt statutory or regulatory rules only when it is plain that existing supervisory enforcement powers are inadequate or that new standards of conduct are necessary for the entire industry. We recognize the powerful temptation to reimpose restrictions in the hope of controlling changes that appear destabilizing, that disrupt old patterns of thought and activity and that are leading to an uncertain future. It is a fallacy to believe that legislation can return us to the old order.

It is now clear that some misunderstood the meaning of the 1980 and 1982 bills and confused deregulation with license. This misreading has led some entrepreneurs and

institutions to look upon an insured S&L as the best new means to get rich quick. They were clearly wrong. But the response to them must not be an imposition of rigid new requirements on the entire industry. New blanket restrictions and prohibitions are not likely to end foolish risk-taking or fraud, but will constrain responsible and prudent institutions. Locks keep only honest people out.

What can government do? What should government do? My answer is an old-time one: stricter supervision of every aspect of insured institutions and swift discipline of those who confuse flexibility with license. Congress must be certain that the regulatory agencies have all the authority necessary to supervise and discipline any person that can affect the conduct or soundness of an insured institution. Congress must ensure that the agencies have the resources and quality personnel -- that means well-paid personnel -- to get the job done. The agencies must be diligent and vigilant in all their supervisory activities. Applications should be carefully scrutinized to ensure that only quality people who appreciate their fiduciary responsibilities are in control of insured institutions. Examinations should ensure that those standards are being followed in every phase of an institution's activities. When individuals or institutions fail to meet those standards, they should be disciplined quickly and with appropriate severity. The focus of regulatory effort should not be in Washington, but in the field where the action is.

My remaining testimony will focus on a number of specific issues as they affect the thrift industry -- which I believe encompasses savings banks like Washington Mutual and savings and loan associations, whether state or federally chartered or insured by FDIC, FSLIC or a state-created fund, as well as credit unions and state-chartered companies that make consumer loans and sell thrift certificates (called variously industrial banks, industrial loan companies, Morris Plan banks, thrift and loan companies, etc.). Although the principles and policies reflected in my testimony appropriately should be applied to both the banking and thrift industries, the bulk of my testimony will concern the thrift industry. I will first review the events in the last five years that have shaped where we now are and then discuss specific issues.

The Thrift Industry in the 1980's: A Time of Crisis

Recent history illustrates our belief that rigidities cause problems, and that flexibility within a framework of fiduciary responsibility and supervision is the key to the long-term survival and stability of the thrift industry.

Until the late 1970's, the thrift industry occupied a relatively secure and limited place in the American financial system. For one hundred and fifty years, savings banks had been specialized institutions that encouraged consumers to

save, that made consumer and home loans, and that invested in securities and other investments according to standards of prudence and diversification. The business of most savings and loan associations primarily involved taking savings deposits and making home mortgage loans. Interest on deposits was subject to a statutory ceiling (generally referred to as Regulation Q), which permitted thrifts to pay 1/4% above the maximum rates for banks. Mortgages were typically made for thirty years at fixed rates. Because of the positive spread between predictable mortgage interest and the cost of funds from regulated deposit interest rates, the industry was stable and generally profitable.

In the late 1970's and early 1980's, powerful forces of change destroyed this relatively simple and undemanding world. Fundamental legal and economic changes caused the cost of funds of thrifts to become both higher and more variable. Market interest rates moved to historic highs and stayed in a higher range than ever before. The securities industry used new technologies to develop money market mutual funds and the Cash Management Account, which competed directly with bank and thrift savings and transaction accounts and paid market interest rates significantly higher than those permitted thrifts and banks under Regulation Q. The phase-out of the Regulation Q ceiling begun at this time removed the legal constraints that had helped to keep cost of funds below market

rates during earlier periods of high interest. As a member of the Depository Institutions Deregulation Committee, I voted to lift the Regulation Q ceiling. But it came ten years too late; ironically, the high interest rates that made it possible also made the timing wrong. For the thrift industry, deregulating rates paid on savings accounts was equivalent to a multibillion dollar one-time tax.

The result was that in 1981-1982 most thrifts experienced sharp losses as their cost of funds exceeded the yield on their assets. Because established thrifts had asset portfolios made up substantially of mortgages at fixed rates that were below the expected cost of funds in a high-rate environment, the long-term survival of the thrift industry, and especially savings and loans, was cast in serious doubt.

In response to the thrift crisis, Congress, the Bank Board, and a number of the states adopted policies designed to provide new sources of revenue to thrift organizations by permitting diversification and expansion of their financial products and services. Institutions were given authority to make a wider range of consumer and business loans, subject to limits designed to maintain savings and loans' commitment to housing finance and to encourage prudence. This policy was embodied in both the Garn-St Germain Act in 1982 and the Bank Board's regulations. Combined with emergency assistance programs, these provisions were intended to permit the survival

of a thrift industry -- and thus to preserve the deposit insurance funds, especially the FSLIC -- and prevent a widespread financial crisis. The essential thrust of public policy through 1982 and 1983 was to provide thrifts with the flexibility to design and implement a business strategy appropriate in light of the competitive, economic, and financial circumstances of its market and position in that market and to move quickly to respond to financial and technological innovation. For well-run and responsible thrifts, Garn-St Germain provided the keys to long-term survival. To change directions and impose restrictions would threaten the fruits of that policy before they have had time to grow and mature. That was the right policy then, and it remains the right policy now.

It is now plain, however, that in some institutions the message of deregulation was read to mean no restrictions. Moreover, in a few states -- notably California and Texas -- the laws governing state-chartered savings and loans were changed. Old standards of diversification and prudence were discarded, and provisions were enacted that would in effect permit an S&L to invest all its assets in any activity. The result has been that a relatively small but highly visible portion of the savings and loan industry became high flyers. Other institutions developed asset problems because ~~they~~ did not know how to use their new powers. They have abused their responsibilities to the deposit insurance system and their

depositors by overcommitting their assets in real estate development, common stocks or, more recently, junk bonds, not to mention a wide variety of wholly unrelated commercial enterprises.

The Bank Board under Chairman Gray has responded appropriately by requiring diversification and limiting go-go activities. But despite the diligent efforts of the seriously understaffed Bank Board and other regulators, irresponsible, and at times fraudulent, activity has caused S&L failures, precipitated the crises in Ohio and Maryland, and placed severe pressures on the FSLIC fund. As Chairman Gray pointed out in his testimony before this Committee, most problem institutions are currently saddled with bad assets, in addition to interest rate mismatches: Whereas three years ago, eighty percent of FSLIC cases were primarily the result of high interest rates, last year seventy percent of the FSLIC cases were characterized by bad assets. It is this obviously serious and longer term problem that has led many to propose reregulation and the imposition of restrictions. But we would emphasize that the problem is not deregulation or the expansion of powers, but the failure of institutions to exercise their powers according to fiduciary principles.

This point is well illustrated by the experience of another segment of the thrift industry -- the New England

savings banks -- institutions that I know well, as a former Connecticut Banking Commissioner. As demonstrated by the accompanying table, state-chartered savings banks in the six New England states have capitalization and profitability at rates double those for federally insured savings and loan associations. In 1984, when the average return on assets for S&L's was .19%, the average return for New England savings banks was three times higher (.59%); the lowest rate of return in any New England state was double the S&L average.

COMPARISON OF PERFORMANCE:
NEW ENGLAND SAVINGS BANKS VS. INSURED SAVINGS AND LOANS*

<u>State</u>	<u>Average Surplus Ratio</u>	<u>Return on Average Assets</u>
<u>New England Savings Banks</u>		
Connecticut	6.6%	.49%
Massachusetts	7.3	.40
Maine	7.4	.72
New Hampshire	8.9	.87
Rhode Island	7.7	.69
Vermont	5.6	.39
<u>All Federally Insured Savings and Loan Associations</u>	3.9	.19

/*/ Data for income are full-year, after-tax income as a percentage of average assets for 1984. Surplus figures are ratio of regulatory surplus or net worth to assets as of December 31, 1984. Only New England savings banks listed. Source: National Council of Savings Institutions.

These savings banks have achieved such results by exercising loan and investment powers substantially broader than permissible for federal thrifts and by applying management and regulatory standards based upon fiduciary principles. Their investment powers include leeway investment powers which permit them to invest in any type of security, subject to the prudent man rule of trust law. They have legal flexibility to respond to markets in their states by offering a wide array of commercial and consumer loans, including of course home mortgages, and to invest -- within specified limits -- in both equity securities and real estate. Under the supervision of state and federal agencies, these powers have been exercised prudently and profitably. As with NOW accounts, this experience reminds us of the traditional role of the states as sources of sound banking practices.

Let me make plain at this point that the principles and history I have been discussing are based on my 27 years in banking. I have lived this history. I have wrestled with these issues as both a regulator of depository institutions and a banker. At the beginning of my career I worked for ten years as a national bank examiner. I later served for three years as the Commissioner of Banking in Connecticut. From 1977 to 1982, I served as chairman of the National Credit Union Administration Board. After more than fifteen years as an examiner and regulator, I know first hand the standards that are necessary for safe and sound banking.

But as a commercial banker for seven years in the sixties and seventies and now as a savings bank executive, I also know what is necessary for an institution to survive in the present environment. When I became President of Washington Mutual in 1982, it was experiencing one of the worst years in its history because interest rates had skyrocketed. In the ensuing period, my bank developed a new business strategy based upon diversification of products and services made possible by our legal flexibility under state law and built upon ninety years of service to Washington families.

Founded in 1889 as a building and loan association, Washington Mutual throughout its history has been a thrift organization dedicated to serving the financial needs of families in the State of Washington and the Pacific Northwest. It converted to a savings bank in 1917, in large part because its directors believed that the operating flexibilities and stricter fiduciary duties of savings bank management under state law were more appropriate than the more wide-open provisions applicable to building and loans. Washington Mutual has maintained these high standards of operation since that time.

After experiencing losses during the high interest rate years of the early 1980's, Washington Mutual determined that it could best serve its customers' needs and preserve its

own stability and prosperity by offering a full range of financial services. To that end, in 1982 we became a stock institution and raised new capital in the public markets. In that year, we also acquired Murphey Favre, Inc., a general securities brokerage firm that was established in 1888, and Composite Research and Management Co., a registered investment adviser which manages mutual funds distributed by Murphey Favre. In addition, since 1980, we have owned a life insurance company, and in 1983 we began to offer our customers a complete range of quality insurance products through a wholly owned full-lines agency. We are able to offer these securities and insurance products to our customers in our 54-office branch network.

Our customers have responded positively to this broad range of products and services and have made our securities and insurance firms profitable members of the Washington Mutual family. Over the long term, we believe that the revenues and profits from these companies and the enhanced customer loyalty that they help to produce will contribute significantly to the strength and stability of Washington Mutual. Without the flexibility provided to us under state law, we believe that our future prospects would be much less bright than they now are.

WHAT CONGRESS SHOULD (AND SHOULD NOT) DO

In my remaining testimony, I will discuss a number of major issues affecting thrifts now before the Committee and the Congress, including: new bank powers, expansion of the Glass-Steagall Act, a "thriftiness" test, limits on joint marketing, a lifetime cap on adjustable rate mortgages, state powers, and enhanced supervision. My views and the conclusions that I draw from them may be contrary to the current mood and fashion. They are based upon my career as a banker and regulator and my understanding of the events during the last fifteen years that have determined our present circumstances. I also believe that they embody principles that have governed our banking system for over a century, principles that we should reemphasize as we move into an era when broader powers and flexibility are essential for the health and stability of both individual institutions and the system as a whole.

1. Build Upon the Garn-St Germain Act

The legislation enacted in 1982 under your leadership, Mr. Chairman, was a sensible step forward. It addressed the thrift crisis by granting the regulators new and flexible authority and by providing thrift institutions enhanced operational flexibility and a greater diversity of asset powers. These approaches should be carried forward in any new legislation.

A corollary to the enhanced asset and investment powers of thrifts provided in Garn-St Germain should be a broader range of powers for banks and bank holding companies. This position is not in our parochial interest, nor is it fashionable, but it is good policy. Commercial banks have traditionally possessed greater asset flexibility than thrifts -- a fact that helped them weather the interest rate revolution of the early 1980's in relatively better shape. Nevertheless, they are subject to the same pressures on spreads as thrifts and to the same new competition from nonbanking financial service companies.

We believe that the powers provided in S. 2851 should represent only a starting point for an expansion of bank organization powers. The argument against new bank powers is often couched in terms of safety and soundness, but we all know that the real opposition comes from those who don't want new competition. Whether new statutory powers are granted or not, the Federal Reserve Board should be more flexible in reviewing applications under Section 4(c)(8) of the Bank Holding Company Act.

I would like to comment only on one proposed power -- underwriting commercial paper -- because I believe it illustrates how rigid rules can undermine safety and soundness. The question about the ability of banking

organizations to underwrite commercial paper is the result of a Supreme Court decision last year that found commercial paper a "security" for purposes of the Glass-Steagall Act, which consequently cannot be underwritten by a bank.

Banks should be permitted to underwrite and sell short-term commercial paper because it is functionally equivalent to the commercial lending that is the core of a commercial bank's lending business. In the last five years, the value of commercial paper outstanding has more than doubled -- from \$113 billion in 1979 to \$257 billion at present. This dramatic growth reflects the ability of high-quality borrowers to go directly to the public markets to secure short-term credit, which traditionally has been provided by commercial banks. This development has deprived those banks of relatively lower-risk loan business and has forced them to lend to relatively less creditworthy borrowers. Marginal risk to the deposit insurance funds has consequently increased. There is no reason to deny commercial banks the opportunity to serve the most creditworthy corporate customers just because their borrowing vehicle is now a "security" rather than a loan.

2. Do Not Expand the Coverage of the Glass-Steagall Act

In the last Congress new restrictions on the securities activities of thrifts were proposed. At present two sections of the Glass-Steagall Act apply only to commercial

banks that are members of the Federal Reserve System ("member banks") and restrict their affiliations with securities underwriters and dealers. These are Sections 20 and 32. Section 20 currently prohibits a majority control relationship ("affiliation") between a member bank, and a firm "engaged principally" in securities issuance, underwriting, public sale or distribution. Section 32 currently prohibits any person who is "primarily engaged" in securities issuance, underwriting, public sale, or distribution or serves as an officer, director or employee of a firm engaged in such securities activities from serving at the same time as an officer, director or employee of a member bank.

S. 2851 and S. 716 would expand the restrictions of Sections 20 and 32 to apply to affiliations involving all federally insured banks. S. 2851 would also expand their coverage to apply to affiliations involving FSLIC-insured institutions, although it expressly excepts certain activities. I believe there are good reasons to oppose any such expansion.

First, and most important, under present law thrifts and state nonmember banks are beginning to engage in securities activities through affiliates that are consistent with safety and soundness and bring many benefits: improved service to customers, enhanced efficiency of the institution's operations,

and greater profitability and stability through diversification. Without clearcut evidence of abuse -- and I know of none -- these opportunities should not be taken away. If abuses are identified, statutory and regulatory provisions adopted since the Glass-Steagall Act, especially the securities laws, are available to correct them.

Moreover, the federal regulatory agencies have tended to interpret Glass-Steagall in a conservative fashion and have been responding to the expansion of banks and thrifts into securities activities in a cautious and restrictive fashion. Indeed, they have incorporated Glass-Steagall principles in orders and rules governing affiliation with securities firms. That approach counsels against the need for legislation.

We believe that the agencies have been unnecessarily restrictive. For example, the recent FDIC regulation governing the securities activities of state nonmember banks includes a number of restrictive requirements -- including particularly one requiring separate entrances for a securities office located in a building where its bank affiliate has an office. Likewise, the terms "primarily engaged" and "engaged principally" have been interpreted too restrictively and contrary to their plain meaning. Those terms should refer to activities that represent a substantial portion of a firm's business -- at least 25 percent -- and that are also the single

most important portion of its business. As we will discuss further below, the difficulties in applying Glass-Steagall make it inadvisable to extend its coverage. It is preferable to work out the appropriate application of Glass-Steagall in the context of agency rulemakings and supervision.

We would further point out that Glass-Steagall is being used by the securities industry to keep out a potentially significant source of competition. In light of the wave of securities firm combinations that have dramatically decreased the number of competitors in that industry, the wisdom of maintaining a Glass-Steagall barrier to new competition is questionable.

There are also a number of more technical legal reasons not to expand the coverage of the Glass-Steagall Act, which I will discuss in some detail. The Glass-Steagall Act was poorly drafted when written, and its intended scope, particularly in light of parallel pieces of New Deal legislation, cannot be determined from its language. We know it was enacted following extensive Congressional hearings into the securities activities of commercial banks and their affiliates during the boom and bust period of the Twenties and the Great Depression. We know that Congress identified certain abuses, primarily related to self-dealing and other conflicts of interest, arising from the combination of commercial banking

and investment banking in a generally unregulated, go-go environment. We also know that the New Deal Congress enacted the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company and Investment Advisor Acts of 1940 to address many of these abuses.

These same Congresses enacted the Federal Deposit Insurance Act, Federal Home Loan Bank Act, Home Owners Loan Act, and the National Housing Act to insure banks and thrifts and to create federal thrift charter. This legislation did not apply Sections 20 and 32 of Glass-Steagall to thrifts.

Further, we know that the effort to apply Glass-Steagall to the very different banking industry of the last twenty years has become irretrievably enmeshed in turf battles between the banking and securities industries. In the repeated litigations that have resulted, the adversarial process has done more to obscure than illuminate the Act and its purposes. A gloss of judicial rhetoric has been placed on Glass-Steagall, but candid practitioners and the courts remain perplexed as to its proper meaning and scope. This fact was most graphically illustrated last year in parallel cases brought by securities industry groups challenging the legality of banks' offering commingled funds for Individual Retirement Account customers. The federal court in California held that the funds violated Glass-Steagall. A few months later, the

federal court in the District of Columbia held that a factually indistinguishable fund was not barred by that Act. When a statute can be interpreted by the courts without any greater consistency or predictability, it is seriously flawed.

Let me illustrate the inherent uncertainty and potential overbreadth of Glass-Steagall with one further example. Each section of Glass-Steagall refers to the "underwriting" of securities, but does not define that term. It is clear that Congress used that term to refer to the activities of investment bankers who bring an issue of securities to market by contracting to purchase the issue from the issuer and resell it. The issuer in this context is typically a business corporation seeking to raise capital in the public markets. But as you know, for the purposes of the federal securities laws, the term has been much more broadly defined to cover any person who has purchased from an issuer with a view to distribution of a security or who participates directly or indirectly in such an undertaking. Under the securities laws, the underwriters include everyone from the lead investment banker in New York that manage the underwriting to the ordinary "selling broker" in Wenatchee, Washington, at the other end of the distribution chain who only sells the security to a customer. No such broad definition need be adopted for Glass-Steagall purposes.

There is a fundamental distinction between corporate finance activities of the investment banker and selling broker activities. The selling broker's role is limited to recommending and selling a product packaged by the managing underwriter, who engages in corporate finance activities with regard to that product. But the selling broker must participate in the selling group in order for its customers to obtain products for which there is no secondary market. Selling brokers are typically regional and local firms -- like our Murphey Favre subsidiary -- which are removed from the nation's money centers and generally participate in underwriting only as a member of the retail distribution network. The primary underwriting activities of such firms represent only a small portion of their business and are generally on behalf of local or regional companies too small in size for national investment banking houses and of interest to investors primarily in their own locale.

Selling broker activities do not give rise to the safety and soundness concerns involved in corporate finance activities. They are only distributors and do not have any capital at risk in the underwriting. Consequently, it should be unnecessary to consider the selling broker's activities "underwriting" for purposes of Glass-Steagall. The FDIC took this position in its rulemaking, but because of the murkiness of the statutory language and the unpredictability of its

interpretation by the courts, it is anyone's guess what the outcome would be if the issue were litigated.

These facts lead me to conclude that no reasonable public policy purpose can be served by expanding the coverage of the affiliation restrictions of Glass-Steagall to state nonmember banks and thrifts. There is no evidence of a problem with securities activities presently being conducted by affiliates of these institutions. Do not force another group of institutions to deal with the confusion that already surrounds those provisions. If it's not broken, don't try to fix it.

Before any new restriction on the securities activities of thrift affiliates is considered, a policy basis must first be established through hearings that should thoroughly examine whether the securities activities undertaken by thrift organizations have resulted in any actual problems or abuses and whether Glass-Steagall-type restrictions or an approach more appropriate to contemporary circumstances are needed.

3. Impose No New Thriftness Test

Both S. 2851 and the bill reported by the House Banking Committee last summer contained a "qualified thrift lender" test that had the stated purpose of ensuring that

thrifts continue their orientation to housing finance. In testimony this year, warnings about "non-thrift thrifts" have been sounded, and a stricter thriftness test proposed.

I urge you to reconsider this issue. First, imposition of a thriftness test on traditional savings banks (as opposed to savings and loans that have changed their names) would fail to recognize their historic character and mission and would therefore be unfair. Moreover, even for savings and loan associations a more restrictive thriftness test might be unsound and contrary to the long-run stability and viability of the industry.

As I have already indicated, traditional savings banks have always been genuine thrift institutions: they have promoted savings. They held depositors' savings and concentrated their lending on family credit needs. This continues to be the case. Less than five percent of Washington Mutual's deposits are in NOW accounts; the rest are time and savings accounts. Likewise, home mortgages represent by far our largest asset, and we would probably qualify under the thriftness test in current law. To impose a thriftness test tied to home mortgages on savings banks would be inconsistent with their broader, but historically proven and genuine, role as thrift institutions. If a "thriftness" test is deemed necessary, it should not be tied to a single type of asset.

Indeed, the thriftiness test in S. 2851 would penalize traditional savings banks. Even with a ten-year phase-in period, an institution having "only" 40 percent of its assets in residential mortgages would be required to concentrate its new lending almost entirely upon mortgage lending in order to meet a 60 or 65 percent asset test by the end of the period. That is surely unwise. Moreover, to restrict savings bank access to the Federal Home Loan Bank System because of a failure to meet such a test would be truly unfair.

Second, a more restrictive thriftiness test is also contrary to the long-run soundness of savings and loans, the other principal component of the thrift industry. The volatility of interest rates requires that institutions have maximum flexibility in managing their assets. In a world of deregulated liabilities, it would be unwise to require thrifts to concentrate their assets in a single type of long-term asset. Even adjustable-rate mortgages provide only limited protection against sharp interest rate swings. Most important from a risk standpoint, mortgage lending is tied to the cyclical housing market.

Moreover, the mortgage markets have changed. Competition has narrowed spreads, particularly because many of the new lenders operate without the expense of a brick-and-mortar branch system. The peculiar, traditional role

of thrift institutions as the predominant holders of mortgages is under sharp challenge by a host of new suppliers of mortgage credit. In this changing and at times difficult market environment, the wisdom of tying the S&L industry by statute even more closely to residential housing is likely to increase, not decrease, risk to the FSLIC fund.

4. Impose No New Limits on Joint Marketing

The Board of Governors of the Federal Reserve System proposed two weeks ago that thrifts and nonbank banks be prohibited from engaging in joint marketing of products and services with their affiliates. This draconian proposal has been put forward without the presentation of either a policy or factual basis to support it. We believe that without a clear showing of a need for such a provision, based, for example, upon evidence of anticompetitive activity, concentration of power or conflicts of interests, any such proposal should be rejected.

Joint marketing arrangements conducted within the boundaries of existing law offer both efficiency and flexibility to the depository organization and convenience and economy to the customer. We all are aware of the expensive brick-and-mortar branch systems that banks and thrifts typically operate. Permitting a wider variety of products and services to be offered at those locations will increase

revenues without raising costs. This represents a desirable efficiency that can lower the costs of products and services to the customer. In an era of narrower margins and heightened competition, that kind of efficiency should be promoted, not restricted. In addition, the customer has the convenience of "one-stop shopping."

Moreover, existing law addresses many of the concerns represented by such a proposal. Both the general antitrust laws and specific provisions applicable to banks, bank holding companies, thrifts and their holding companies expressly and comprehensively prohibit tie-ins. Further, in the increasingly competitive market for financial products and services, it is highly unlikely that any institution has the market power necessary to engage in even subtle forms of coercive behavior. Without a showing of abuse, no arbitrary limitation should be imposed on an institution's flexibility in determining how best to deliver products and services.

5. Do Not Place a Cap on Adjustable Rate Mortgages

S. 2851 was amended on the floor with a provision that would place a lifetime ceiling of five percent on interest rate increases in an adjustable rate mortgage. Although we are currently including such a ceiling on the adjustable rate mortgages we are writing, I oppose any effort to write a ceiling into legislative stone. During the last two years,

interest rates have been moving in a range that is historically high, but below the ruinous levels of the preceding period. In the past two years, lifetime caps of five percent have been offered as a feature of ARM's in many parts of the country. Those caps are the product of competition, not government fiat. But if market conditions change and the forces that produced a prime rate over twenty percent re-emerge, we must have the flexibility to adjust all the terms of our adjustable rate mortgages. ARM's were intended to cure the inherent problems of fixed-rate mortgages. A statutory ceiling would reduce the necessary flexibility of that instrument.

6. Preserve State Powers

The issue of state powers is one of the most difficult issues we face. On the one hand, as Justice Brandeis pointed out at the beginning of this century, the states in our federal system are "laboratories of democracy." The ability of a state to authorize its institutions to experiment and to be innovative is a strength of our federal system. That was certainly our experience in New England, where I spent almost twenty years as an examiner, banker and regulator. We are all familiar with the fruits of the NOW account experiment in New England. In addition, many New England thrifts weathered the crisis of the early 1980's in better fashion than much of the thrift industry because of their broader loan and investment powers. When interest rates went through the roof these

institutions already had relatively diversified loan portfolios containing prudently limited quantities of higher yielding, short-term commercial and consumer loans.

But on the other hand, as I have already indicated, a few states have taken actions that in retrospect were not well thought out and inconsistent with our federal system. Prime examples are recently enacted statutes in California and Texas that authorize state S&L's, which must be federally insured, to invest up to all of their assets in any activity, in violation of basic standards of diversification and without the restraint of the prudent man standard. South Dakota has stood the federal system on its head by authorizing "neo-wildcat banking." Under a 1983 statute, an out-of-state bank holding company can acquire a South Dakota bank that may exercise a full range of insurance powers -- but only so long as those powers are exercised out-of-state and not in competition with South Dakota insurance firms. Under a guise of state prerogatives, South Dakota is attempting to help out-of-state companies engage in a nationwide insurance business that is foreclosed to them directly under federal law -- and of course that would continue to be foreclosed to them in South Dakota. That is a perversion and, if permitted to work, it would reduce the entire financial system to the lowest common denominator of any state that would trade powers for a promise of a few jobs.

Federal deposit insurance and the need for a stable financial and economic system represent vital federal interests. The international reaction to recent events in Ohio has underscored the significance to the country of what happens at the state level. State actions cannot be allowed to undermine those federal interests.

This imprudent exercise of state powers has led some to advocate legislation that would effectively federalize the state banking and thrift systems or that would confine the business of state institutions within the borders of their states. I oppose those quick-fix answers. They would effectively end the dual banking system at a time when that system is on the whole functioning effectively and constructively. Indeed, the movement toward regional and reciprocal interstate banking laws by so many states is an important reminder that the dual banking system is strong and creative. Further, there is no grass roots political consensus in favor of ending the dual banking system. Unless such a consensus emerges, our presumption should be in favor of state powers, especially those that have been on the books for many years. On the whole, the states have played constructive roles and been sources of strength in maintaining a safe and sound banking system. Particularly in light of the trend toward regional banking, it would be unfair and unworkable to confine state institutions within state borders.

Of course, federal power can appropriately be exercised when a state permits inherently unsound activities or acts in a discriminatory fashion to achieve parochial objectives. No bank holding company has yet been able to acquire a South Dakota bank with insurance powers. By regulation, the Bank Board has limited direct investments in non-traditional activities by state S&L's. Thus, the federal agencies now have the power to stop state abuses. But the agencies should override state law only on the basis of a fully developed record that demonstrates the concrete need for federal action and the legitimacy of the specific measures adopted.

7. Enhance the Supervisory Capabilities of the Regulatory Agencies

The topic we have saved for last may be perhaps the most important of all. My testimony thus far has emphasized that banks and thrifts should not be burdened with statutory or regulatory restrictions that impede them from responding flexibly to the needs of their customers. But government should not be passive. On the contrary, banking and thrift regulators should monitor, supervise, and correct the activities of institutions subject to their control, and Congress must ensure that the agencies have all the resources and powers necessary to do that job effectively. Essential to agency effectiveness is an ample professional staff, who are

drawn to public service and kept there by salary levels far higher than presently in place.

The banking agencies and the Bank Board already have extensive powers. In S. 759, the Bank Board has requested amendments to make plain that it has the power to reach any person or entity that can affect the solvency, soundness, or prudent conduct of an insured institution's affairs, including subsidiaries or affiliates and individuals who can affect an institution without being an officer, director or employee. We support those amendments.

The full panoply of corrective measures, including criminal sanctions, when appropriate, should be brought to bear on institutions and their managements that are not conducting their businesses according to high standards of responsibility. Pressure should be placed on institutions to remove officers and managerial personnel who do not meet high standards of competence and integrity. For institutions, the applications process and the examination report should be used vigorously to bring about corrective actions. If significant questions arise concerning an institution's performance, an operating agreement that maximizes market responsiveness but minimizes risk should be entered into.

A greater and more pressing need is a substantial increase in supervisory personnel and resources. Safety and soundness are maintained by a supervisory system capable of monitoring all institutions in the system and identifying developing problems. Institutions do not get into difficulties because they have broad powers, but because they use the powers they have foolishly, irresponsibly or fraudulently.

Continental Illinois National Bank did not reach the brink of collapse because it had abused new and exotic powers, but because of legal restrictions and inadequate supervision and managerial control. Its bad loans became a problem of gigantic proportions because both the bank's internal controls and its supervisors had failed to identify them early on. Its public crisis was precipitated by the fact that legal restrictions on branching denied it a large base of stable consumer deposits and forced it to rely on volatile purchased money.

A principle goal of supervision and examination should be to determine whether an institution has the technical competence to make sound investments and the internal managerial controls to ensure that credit policies, investment standards, and diversification requirements are being adhered to. These are the fundamentals of banking. If an institution cannot demonstrate that it has such competence and controls, then its investments in relatively risky assets -- whether commercial construction and development loans, direct real

estate development or investments in securities -- should be limited as a matter of supervisory policy. This goal cannot be achieved if supervisory personnel are stretched thin or are not sufficiently skilled.

This goal can also be furthered by a regulatory requirement of prior notice and opportunity for denial before an organization enters a new line of business. Under such a procedure, the agency could ensure that an institution has the necessary personnel and capital to undertake expansion into new activities. That approach has been used at times in the past and is one of the revised bank holding company procedures in S. 2851. As a former regulator, I would support general use of this supervisory method.

Enhanced supervision is also needed because banking is more complex than ever. For example, examination of the security of a bank's computer system requires highly technical and sophisticated skills. At least as demanding is the task of examining and monitoring an institution's use of the sophisticated methods now available for managing interest rate risk through interest rate options and swaps, and futures contracts. Bank examiners with specialized technical skills are essential.

To ensure the soundness of the depository system in a relatively unforgiving environment, we must make enhanced

supervisory capability a major priority. That will require significantly greater budgets and salary scales capable of attracting and keeping skilled professionals. A principal reason why the banking agencies and Bank Board have had difficulties keeping on top of the burgeoning number of problem institutions in recent years is the ceiling on the overall number of examination and supervisory personnel imposed on them. Indeed it has been reported that the Office of Management and Budget has recently turned down an urgent Bank Board request for more staff. In light of the present crisis and the trillion-dollar liability of the deposit insurance funds, it is indeed pennywise and pound foolish to require the agencies to perform their critical supervisory functions with staff that is obviously inadequate to the task.

Let me make plain that when I say "inadequate," I am not referring to the quality and dedication of the agencies' supervisory staff. I know from my five years as an agency head in Washington that we are fortunate to have many highly qualified and hard working individuals in these agencies. Indeed, in a time of unprecedented workloads, the depository agencies' staffs have put in extraordinarily long hours, have travelled extensively around the country and have made significant personal sacrifices in order to help ensure the soundness of our banking system. And they have done so for salaries far below what they could often command in the private

sector. But there are limits, and we should recognize that when it comes time to send children to college, a government salary is frequently too meager, and many of our best agency professionals then leave. No one can fault that decision, but it is folly to let that continue to happen.

There is already one bright spot. I was pleased to learn that the delegation by the Bank Board to the regional Federal Home Loan Banks of most ongoing supervision and examination has been accompanied by the adoption of salary schedules for professionals substantially higher than is possible under the federal civil service system. But this is just a beginning, and the Bank Board cannot do the job alone.

In this session, Congress should take whatever steps are necessary to ensure that all the agencies are provided with substantially larger examination and supervisory staffs who will not be subject to an unrealistically low civil service salary ceiling that builds in turnover. Neither the depository institutions nor the depositing public in the wake of the Ohio and Maryland crises will object if spending for supervision were increased dramatically. An expansion of quality staff will not occur overnight. We should begin the task immediately.

CONCLUSION

In summary, the challenge facing bank management, regulators, and state and federal legislatures is managing their tasks in light of the vast changes being brought about by the economy, technology, historically high interest rates, competition and consumer preferences. Managing a deposit-taking institution involves the exercise of fiduciary care in the interest of the body of depositors who entrust their savings and temporary funds. Regulation has proved necessary to balance the sometimes conflicting demands of business entrepreneurship and those fiduciary responsibilities. Good government would suggest that regulation not interfere with the basic operation of the marketplace, but instead limit its role to establishing the minimum standard of conduct for prudent operation of an institution. Many of the arguments presented to the Committee in opposition to greater flexibility for banking institutions represent requests for regulatory protection from competition. In the long run, such "protections" will not enhance safety and soundness, but increase risk.

On the other hand, federal deposit insurance is not a license to speculate with depositors' funds. Those who do not act with fiduciary care should receive the harshest treatment from the law.

This committee and the Congress should act to permit greater flexibility in bank and thrift operating powers in order to accommodate these fundamental changes. At the same time, it is imperative that the regulatory agencies be provided the necessary regulatory tools and financial resources to ensure that institutions exercise their powers according to high fiduciary standards. Act now to enlarge agency examination and supervisory staffs and to remove them from present low salary scales. To ensure a strong financial system and economy in the future, federal policy should provide greater operating freedom coupled with fiduciary responsibilities for institutions and a modern regulatory system.

The CHAIRMAN. Mr. Evans.

STATEMENT OF C. LAWRENCE EVANS, JR., CHIEF OPERATING OFFICER AND GENERAL COUNSEL, ACACIA MUTUAL LIFE

Mr. EVANS. Thank you, Mr. Chairman and Senator Gorton.

I am Larry Evans, chief operating officer and general counsel of Acacia Mutual Life Insurance Co.

I am here before you this morning to talk to you about the Acacia group as a financial services institution. You have my prepared statement and I would ask that you enter it into the record. I would rather not read my statement, but would rather take just a few minutes of your time to discuss the two major areas of concern that I believe, are shared with the entire life insurance industry.

The first of those—and I don't want to overdramatize, but I have to say it this way—is frankly the survival of the mutual life insurance industry, as well as the jobs of the people who distribute the products and the services that we market to our customers.

Our second concern is whether we will be able to continue meeting the needs and demands of our clients in today's economy. You have been hearing about that economy quite a bit this morning.

First, on survival of the industry, it is no secret—and you've heard about it for a number of years now—that in the early 1980's our clients took a look at the product that we were selling and they said no. We went the route of the thrift industry. Disintermediation was a word that I did not know at that time but I learned quickly. You could not pay your clients a 4-percent rate of return on their money in a time when 14, 18, and 20 percent rates were available. It just did not make sense.

The response to that problem came rather quickly as new products were developed by the industry. But, it was a hard time in our industry, the mutual life insurance industry. Not everyone agreed

with that direction. Many felt at that time and, unfortunately, feel today that the best and proper approach is to roll back, is to freeze, is to maintain the walls between the various segments of the financial services industry.

DEVELOPED NEW PRODUCTS

Acacia did not do that. We did not believe it was correct. We did not believe it would be fruitful. We went forward with the new products. We also recognized that in moving in that direction we were, in fact, moving into what we call financial services, be it securities, be it banking, or be it life insurance. The differences between the products were just starting to disappear.

I don't need to advise any of you as to the problems of walking the crooked road through the regulations of the three diverse industries. It is difficult, but we feel necessary.

I think one of the things that we don't talk about too much, and why I used the word survival as a key issue for the mutual life insurance industry, is that our statutory method of accounting can be very deceptive. The less delivery we make, the less money that comes in. We're not spending \$2 for every \$1 of premium during the first year. Expenses, therefore, are not as high. The more policy surrenders occur, the more loans occur, and the more money that moves out into other organizations, in fact releases money to the bottom line or profit line of the company. Mutual companies financially look very good when sales slow but unless we can recover very quickly, the bright picture is very short-lived. The favorable bottom-line turns around and falters very quickly.

I think the problem is obvious to us now. We had to increase our policy's 4-percent interest rate by 6 to 7 additional percentage points to deliver a market rate of return that was acceptable to our clients. Clients deserve it. With more money being paid out to our clients, less money was available to the company which caused a squeeze between our distribution expenses and income. Our distribution system has been based historically on the ability to find and call clients, meet with them, and sell to their needs.

The statistical rule of thumb to make a life insurance sale—and we've been there for years—is that if you want to talk to one client you've got to make 10 calls. And, out of 10 interviews, you will make 1 sale. In other words, on average it takes 100 calls to get 1 sale.

Generally speaking, each sale produces about \$1,000 in premium the first year, 35 percent of which goes toward the agent's commission. We have found that a young person in today's economy who has been out of college 4 or 5 years expects to earn at least \$35,000 annually. We tell them, "What we can do for you is make sure you will be able to earn \$35,000 a year. We know you're married. We know you've got children and we can do this for you." I say this and people shake their heads no because the numbers just are not there.

But \$35,000 was the average W-2 gross income of our sales personnel in 1984. That was the average. To earn that money, using my 10 and 10 rule at a \$1,000 premium, it would take a person 40

telephone calls a day while they were going across town to make 4 interviews hoping like heck they would make a couple of sales that week in order to average \$35,000 a year.

That is not efficient. We are not efficient in our delivery system. We are talking to clients, clients who have needs, clients who are more sophisticated now. The media has taught them. We have taught them. They have greater needs than just traditional life insurance products. They need additional financial services.

In order for us to build the base to provide our agents a reasonable income, it's necessary that they get in front of people and meet all of those needs. If we can't do it, our clients are not going to talk to us. That is our simple story.

We cannot roll back the marketplace. We need help. We can work through the maze today. It is difficult. It is limited. There's very little expansion.

I'm not talking just about the banking laws. We have the same problems with insurance laws and the securities laws. I think deregulation is necessary. It's necessary in all segments of the financial services industry. We must have the ability as a mutual life insurance company to put more of our money down into our subsidiary organizations. We can't do that under the insurance law. Securities laws impose other restrictions.

Senator, you are making progress with deregulation in banking and we hope and pray that it will continue.

I hear a little bit—I don't want to dwell on it too much, but I hear a little bit about deregulation allowing us to get into a variety of businesses and setting up what I hear is a conflict of interest. I don't agree with that. I think the reverse is true. I think the absence of an ability to provide for a variety of needs causes a conflict.

If the life insurance salesman sees a need that can best be satisfied by a banking service or some other service and he can't sell it, he's under tremendous pressure at that point in time to get his sales hat on and go to work to sell life insurance, and there's where the conflict is in my opinion. I think it would help, not hurt, the conflicts of interest problem if agents can sell a wide range of financial services.

I think deregulation will very much assist the future of our industry, the survival of our industry. Again, I don't need to educate you on Baldwin-United. Baldwin-United exists because of the controls that were on that particular institution during a period when they were trying to survive. What happened to them is exactly what happened to the thrifts. They needed money and they needed money in a hurry. They needed money at high interest rates to meet the demands of their clients so that the disintermediation would stop. They had their answer to it. I don't agree with it. Others have their answers. Our answer is to go forth with all of the financial services.

I want to thank you for your time and I am here for any questions that you might have.

[The complete prepared statement follows:]

TESTIMONY OF

C. LAWRENCE EVANS, JR.
CHIEF OPERATING OFFICER AND GENERAL COUNSEL
ACACIA MUTUAL LIFE

I. INTRODUCTION

Mr. Chairman, and members of the Committee, I am Larry Evans, Chief Operating Officer and General Counsel of Acacia Mutual Life Insurance Company. I appear before you today on behalf of the Acacia Group of financial services companies that now have operations in over 40 states. The Acacia Group includes two insurance companies, a securities firm, a federal savings bank, and several companies specializing in business development programs.

Acacia has only become a diversified company in recent years. Historically, we were a small, rather typical mutual life insurance company. Acacia, created by Act of Congress in 1869, first was a fraternal organization, and later in the 1930's, it became a legal reserve life insurance company providing insurance to the general public. For the next few decades we sold traditional insurance products through the agency distribution system.

Then, in the late 1970's, we recognized that a revolution was occurring in the marketplace. We frankly found that our survival as a company depended upon diversifying and restructuring our product lines and our distribution system. Our analysis showed that we were being severely squeezed from several directions in the new financial services market: (1) our client market wanted more high performance financial products; (2) such products were readily available from an ever increasing list of competitors that included securities firms, banks and even retailers like Sears; and (3) our existing agency distribution system simply was

too costly and inefficient to deliver today's products at competitive prices.

We had to make a hard choice: whether to fight as many segments of the financial services industry have done to try to freeze or even roll-back much of the change in the marketplace, or whether to "retool" and go forward as aggressive competitors in today's evolving market. Quite candidly, we carefully considered the first choice, but after months of market research and internal economic analysis, we concluded that we had no option but to "retool" and to diversify if we hoped to survive and prosper. Although we recognized that Acacia might be able to help delay change for a brief while, we saw that the market forces -- which are driven by consumer needs, new technology and competition -- would soon submerge us. And, we knew that Acacia would be losing ground in the interim because of our high distribution costs and our narrow product lines.

Therefore, Mr. Chairman, Acacia opted for change -- for survival -- and we believe for a course that is allowing us to provide our present and future clients with products that satisfy their needs at competitive prices. Just as the market is no longer a narrowly defined "insurance," "securities" or "banking" market, Acacia is no longer simply an insurance company. The Acacia Group now is a growing and diversified financial services organization offering insurance, securities products, banking, financial planning and other services. And, I should add, our agents are prospering as we go through this "retooling" process.

They now can provide the broad range of products that their clients need. Our new products and retraining programs thus allow them to compete and to earn the levels of personal income that they need.

Before describing how we have diversified to meet marketplace realities, I want to pause to make a plea on behalf of not only the Acacia Group and the many clients we serve, but also on behalf of other companies that find themselves in the same type marketplace "squeeze" that we fortunately recognized several years ago. Congress should not try to turn back the clock or freeze the evolution of a more efficient financial services industry through legislative restrictions that are in reality designed to protect special segments of the financial services marketplace. You should allow the various financial services firms to compete equally in the market.

Please recognize that the market is such today that many insurers and other financial firms simply will not be able to survive if they are legislatively restricted to their narrow traditional markets -- distribution costs are simply too high. Many competitors are now using high volume, impersonal distribution systems and peddling prepackaged products that are not tailored to consumers' best interests. To try to impose a legislative freeze or roll-back on the financial services market would be to sentence many smaller firms to certain death.

Mr. Chairman, my plea is against not only protectionist federal restrictions, but also against similar politically driven

state restrictions. As you know, many of those who fear change and competition have in the past and are attempting today to legislate restrictions at the state level. The "back door" approach to protectionism has created an intolerable burden on firms that must compete in the national marketplace. We urge you to develop federal legislative mechanisms to correct such restrictive state laws.

Acacia believes that healthy competition is the best antidote for concerns about concentration of economic power and conflicts of interest. Acacia, which is quite small relative to the giants of the financial services industry, is willing and able to compete with banks, securities firms and other insurance organizations as long as we can do so on equal terms. If we are unable to do so, we do not deserve to be in the marketplace. We also are willing to be subject to the appropriate regulators in each area. Acacia supports the concept of functional regulation which has been proposed legislation in the last several years.

In short, Mr. Chairman, we favor a level playing field on which all financial services providers can compete to offer insurance, securities and banking products. Unless this is done, many smaller insurers like Acacia, as well as other financial services firms, will be unable to compete successfully with the firms that already can offer customers a diverse list of products.

Now, let me tell you how Acacia has changed to meet the realities and needs of the new financial services market.

II. ACACIA'S RESPONSE TO THE CHANGING MARKETPLACE

1. Response to High Interest Rates and Market Competition

Our risk management products were the first to respond to changes in the marketplace. During the late 1970's and early 1980's, skyrocketing interest rates caused Acacia to redesign its entire product line. Suddenly, our bread and butter product -- whole life insurance -- was unable to compete with investment vehicles like money market accounts and certificates of deposit. Like many other insurance companies, Acacia found that the temptation of double-digit rates of return enticed extraordinary numbers of our policyholders to surrender their policies and invest the proceeds in more interest-sensitive products. This new competition jolted us into a new way of thinking. No longer could we have a simple low-yielding product -- we had to develop a new form of life insurance that would pay consumers interest rates comparable to those offered by the new money market funds and other higher yielding products.

To compete in this new marketplace and to respond to the tremendous drain on our assets, Acacia decided in May, 1981 to unbundle its traditional life insurance product and committed itself to deliver its first universal life insurance product. Universal life permitted us to offer an insurance product whose cash value was sensitive to the earnings of the company. I am proud to say that on October 1, 1981, Acacia was the first major mutual insurance company to offer a universal life product to the public.

Acacia agents could then offer a competitive product to their clients who demanded a higher return on their investments.

Even while we were developing Universal life, we recognized that we needed to create another interest-sensitive product that could compete more directly with and provide similar flexibility to securities and mutual funds. Concurrently, we began to develop a second generation of universal life -- the flexible premium variable life policy -- which is a security registered with the Securities and Exchange Commission. In October, 1984, Acacia became the first insurance company to offer this new form of "insurance" product. This was the first to allow the client to choose from among a series of funding vehicles based on his or her preferred investment philosophy.

Even as we began to market our first universal life product, we realized that creating a new form of life insurance was not enough. We had to respond to the newly developed marketing strategies of not only insurance companies, but also banks, securities companies and even retailers like Sears and J.C. Penny's. The distribution networks and marketing methods available to many of our competitors are stunning. Banks not only have their extensive base of account holders, but also have de facto interstate networks through many special purpose financial operations permitted by the Bank Holding Company Act, and national credit card services. In addition, Sears has over 300 in-store financial services centers from which to market stocks, insurance

and real estate to a daily captive audience of people shopping for anything from refrigerators and lawnmowers to socks and towels.

Our insurance company competitors also have been changing rapidly. Not only are many other insurers following Acacia's course of developing new, interest-sensitive insurance products, but they are changing their marketing strategies and distribution systems. Perhaps learning from the Sears experience, increasing numbers of insurance companies (that traditionally have not had the benefit of frequent periodic contacts with customers) are signing lease arrangements to market insurance in bank lobbies, grocery stores and other locations that bring them into frequent contact with customers. Reports to date indicate these ventures are quite successful. In addition, a growing number of insurers have acquired or are considering acquiring depository institutions, securities firms and other financial services businesses. Many more have been using direct sales techniques to sell insurance products at lower prices instead of marketing through the agency system. In short, Mr. Chairman, we have found that a marketing revolution is occurring in our own insurance industry.

In the face of this changing marketplace, we had no real choice but to recognize the forces of change, plot our own course, and choose our special clients that we are best able to service. To do this successfully, we realized we had to "retool" our company and our agency force. This is the course that Acacia has chosen.

We knew that Acacia had to satisfy the needs of an investor who demanded a variety of financial services. During the

period of 1983-1984, Acacia developed a strategic direction designed to meet these demands. We recognized that successful marketing in the financial services industry today involves first identifying the needs of clients and then designing products to fill those needs. Also recognizing that because of our size we could not market to everyone, we identified a specific sector of the market -- people who manage and work for small and medium-sized businesses. This identification enabled us to design products and services specifically tailored to their needs. Acacia's corporate strategy reflects our strong belief that the client is the ultimate directing force of our business.

Through extensive economic research and market analysis, we learned that our specific market wanted certain insurance and investment products, banking services and business planning services. Our customers recognized that with the advent of electronic funds transfers and the rapid transit of information, they could -- and from a convenience and efficiency standpoint should -- get a certain array of products and services from a single source. If they could not get it from us, they would simply turn to our competitors. Mr. Chairman, this is the key issue for Acacia; it has become integral to our marketing strategy and indeed has served as the catalyst for the substantial changes Acacia has undergone to compete in the financial services market.

Our target market not only demanded risk management through the purchase of life insurance and annuities, but also investment products. Consequently, a search began to acquire

an investment management firm. That search resulted in the acquisition on January 3, 1984 of the Calvert Group Limited, a Washington, D.C.-based investment management firm with about \$2 billion in assets under management. Calvert offers a wide range of top performing investment products and services that now have been integrated into the Acacia Group's marketing and service operations.

Acacia also offers financial services through the Acacia Federal Savings Bank which was granted a charter in 1984 by the Federal Home Loan Bank Board. Acacia Federal is located in the Washington, D.C. suburb of Annandale, Virginia. The addition of Acacia Federal enables us to provide residents of its marketing area with more complete financial services, including mortgage loans, savings plans, checking accounts, and trust services. We view these services as essential to meeting clients' overall financial services needs.

Business development programs compose our fourth line of services. Our particular clients also face rapid changes in their marketplace. To deal with these changes and to benefit from strategic planning, our clients can utilize information services through Creative Business Concepts, organized in 1978 to offer management development programs, or through Taylor Management Centers, acquired in 1983, a strategic planning and project tracking service and provider of work environment systems. In 1985, we developed Enterprise Resources, Inc. which will ultimately serve as a business services company. These organizations permit us to

provide products and services to entrepreneurs from the inception of their enterprises through their growth stages.

2. Response to the Distribution Squeeze

In addition to responding to our specific market's demand for a variety of financial services, our distribution system has had to change with the evolving market. No longer are our career agents able to sell simply traditional insurance products which are fairly easy to explain, nor are they able to collect fairly substantial commissions on each sale of such products. As of January of this year, universal life sales represented 50% of the insurance industry's life insurance sales. Acacia's universal life products are now the lifeblood of our insurance sales. This is extraordinary considering that the commissions received on these sales are relatively small compared to yesteryear's commissions on whole-life products. The hard fact of life from the agent's perspective is that expenses such as commissions had to come down because consumers demanded and were entitled to a higher rate of return to match market rates. Our agents still had to be able to make an adequate level of personal income.

Just as our company has been forced to change, so have our agents. Our agents had to become experts on the new universal life and other sophisticated financial products. Acacia had to institute a complete retraining program for our agents to learn the multitude of insurance and cash value combinations that flexible premiums could produce. Our agents have had to become skilled financial facilitators who can offer clients a complete

portfolio of financial products and charge a fair fee for these services. Our career agents have become affiliated with Calvert in its status as a registered investment advisor. Furthermore, to sell registered securities, all our agents have had to register with the National Association of Securities Dealers and pass state securities examinations.

Our training program continues to be a major commitment for Acacia. The cost of retraining our career agents and upgrading our distribution system, like the cost of developing new products and the necessary computer back-up support, is tremendous. However, we have had no choice but to make these investments to meet our market's demands and to compete with larger, diversified firms. We realize that our customer wants more sophisticated financial investments and that our agents must be professional representatives and must be compensated accordingly. We know that if we fail to set high standards for our agents, we will lose our market and they will be unable to sell enough products to meet their own financial needs.

III. CONCLUSION

Mr. Chairman, I hope my brief summary of how and why Acacia has changed with the evolving financial services marketplace has been helpful to your committee. In conclusion, we support the direction you have taken in seeking a more competitive financial services marketplace. We urge you to consider the needs of the growing numbers of diversified financial services companies like ours that have recognized the natural affinity of financial services products which heretofore have been artificially and inefficiently compartmentalized. We have tried to respond to needs of our clients by coordinating financial needs and offering a range of specially tailored products. We recognize that this is the substance of the new financial marketplace. All we ask is equal access and fair regulation of all participants so that competition can increase. This will clearly benefit consumers and will allow companies to survive and prosper in the financial services business.

The CHAIRMAN. Thank you, Mr. Evans.

Mr. Connell, you made a very strong plea in your testimony for Federal regulators promptly enforcing fiduciary standards on bank officers. I certainly don't disagree with you, but then very rarely does anybody disagree with that concept.

Do you have any suggestions on how we would operationally have that work?

Mr. CONNELL. Yes, Mr. Chairman. There's a difference in the history of mutual savings banks and mutual savings and loan associations.

BEGAN AS CHARITABLE INSTITUTIONS

Mutual savings banks began more closely as eleemosynary institutions where people who had an interest in helping the working person pooled their own money and formed a mutual savings bank, and the laws under which they formed it were much like a private hospital where the trustees had a fiduciary responsibility like the trustees of somebody's estate. So in the culture of the mutual savings bank industry and written in the laws is this requirement of prudential care.

On the other hand, the savings and loan industry has been more entrepreneurial in its historical origins. So as the statutes are written they don't have the strength of the fiduciary responsibility in there.

I think that there can be a crafting of regulation and statute that could impose a fiduciary standard.

There are other aspects of putting standards in there and one is limitations on concentration investment. If you notice, many of these that get into trouble got into trouble because they had too high an obligation to maybe one borrower or a series of borrowers or a type of credit, and many of the savings bank statutes as they evolved had limitations in any one type of investment.

I think more can be done in that area, although I would rather see it done by regulation than statute because things change over time and it's more difficult to change a statute than a regulation. But it certainly can be done through that manner and also through some of these supervisory powers where you can remove an officer or even prohibit a person from having been involved with the institution or the industry—the securities industry, for instance, has the ability to ban people from the securities industry, period, because they have shown themselves unfit. The ESM situation is an example, for instance, of a pattern of behavior going across many institutions in the industry, a pattern of improper behavior. That should be able to be dealt with and the principals should not be allowed to reincorporate another firm a year or two later and begin the same practice.

So there are many ways of protecting the institution, both internally and externally, from that type of behavior.

The CHAIRMAN. The comment has been made by several of our witnesses that we are regulating by laxity and regulating by the lowest common denominator, specifically last week talking about some banks wanting to shift to thrift charters because of less re-

strictions. Ed Gray denied that, but there are people on the other side who make a very strong point that that is true.

Do you think we are facing the problem of regulating to the lowest denominator?

Mr. CONNELL. I think if anyone shifted now to an FSLIC-insured status to avoid oversight, they would be making a very serious mistake. I don't believe that Chairman Gray lacks any interest in the associations operating in a prudential manner.

I believe the shift from one charter to another or one type of insurance has more to do with operating flexibility and has traditionally had more to do with operating flexibility than with lax supervision.

Back in the 1960's when Jim Saxon was Comptroller, there were a number of conversions to national bank charters because of the flexibility in the powers that the Comptroller was operating under at that time. Then there was a shift back to State charters as the burdens of Federal Reserve membership impacted. Much the same goes on shifting from Federal savings and loan charters to State savings and loan charters in order to have consumer banking powers.

So I believe the shift is not to avoid necessarily—I hope it would not be to avoid that type of oversight, but oversight in terms of strong regulation but rather operating power and flexibility.

The CHAIRMAN. How about the other side of the coin, of passing either statutes or regulations for the weak without concern for those who are doing a good job and are strong institutions?

PREFER S. 759

Mr. CONNELL. That's a very serious problem. In other words, penalizing the 95 percent or 99 percent that operate properly to get the 1 percent that don't. That's where I prefer a statute like S. 759 that allows the regulator to reach people that are abusing their responsibility. The credit union statute gave the agency the ability to prohibit a person from participating in the affairs of the credit union, or being on the board of directors, or management if they were either dishonest or engaged in unsafe and unsound practices, whereas the banking statute required the finding of both dishonesty and unfitness.

We were able to deal with managers that didn't behave properly and in one case, a debt collection firm that was engaging in egregious conduct, because our statute was stronger in terms of enforcement capacity. So it's that direction I think the regulation and statute should take rather than limiting operating powers to some common denominator.

The CHAIRMAN. Mr. Evans, you make a very good case for more flexibility in your operation and I would agree with you that 40 calls for 4 appointments for 2 sales a week is not a very efficient delivery system and therefore you would like to have additional products and services to offer to make it more efficient.

That case is made by every segment of the industry the last few years. Does that mean that you are willing to let banks have more flexibility to offer your products?

Mr. EVANS. If I didn't, I think I would be talking out of both sides of my mouth.

The CHAIRMAN. Well, it's refreshing to find someone who isn't. [Laughter.]

Mr. EVANS. Our company has taken the position that they have to be willing to allow all segments of the financial services industry to compete with each other. Our basic position is if we can't compete in the marketplace, we frankly don't belong there. We feel we can and it may sound a little silly, because we are saying we are ready to stand up against the giants, but we are in our own segment of the marketplace and we want to do well there.

The CHAIRMAN. Well, that's a refreshing answer after years of listening to testimony that do have rather significant double standards and how they want to interfere with somebody else's business but certainly keep the regulations on everybody else intact. I thank you for this straightforward and honest answer.

Senator Gorton.

Senator GORTON. Larry, would you comment on Mr. McCormick's testimony, if you will?

Mr. CONNELL. No one wants to be the second last buggy whip manufacturer in the market. Maybe if you're the last one maybe you have some kind of monopoly market.

I don't feel that the industry is necessarily headed for extinction, but I do share concern about a rigid regulatory structure that doesn't allow an institution to meet the needs of the marketplace.

I recall in the Connecticut statute we had a provision for an industrial loan company but in the law there was a limit on the interest rate they could charge to 6 percent, and they all converted to commercial banks. That was the end of that type of institution.

There is a need to have sufficient flexibility to meet the market and even with the competition from other types of companies—retail and industrial—a well-managed company in almost any industry can survive.

What I do notice happening in a little different perspective is that we have entered the postindustrial society in this country. Manufacturing is now down to something in the range of 20 percent of our GNP and going down lower. And I notice that companies that want to be around are shifting their emphasis of their attention from the manufacturing sector to the service sector or maybe high technology, and I notice General Motors buying Northwest Mortgage, Chrysler Corp. announcing that it's going to devote greater attention to financial services.

This is partly because our economy is changing and those companies want to continue. So we have this evolutionary process. I don't believe that any one sector goes out of business altogether, but if you have an artificial constraint such as the underwriting of commercial paper by the banks, there's a real problem in terms of their role in the future and I believe we need flexibility so that this change can be met in the marketplace.

Senator GORTON. Could you comment on Mr. McCormick's comment that the capital requirements would disable banks, even when they are efficient, take away their ability to compete fairly.

Mr. CONNELL. That is a serious problem and would be reflected in probably the way he mentioned it but also in another way that I

think is more profound, and that is that it will reduce the lending activity in this country and the credit available for economic activity and that there is a likelihood that just like the policy of the Federal Reserve in the depression requiring 50 percent reserves, restricted credit and exacerbated the depression, somewhat similar situation could happen in this area except for one thing, and that is we've got so much imagination in our business world that it didn't take more than a couple months or couple of weeks and the financial industry discovered, as they call it, the securitization of loans and the movement of them from the loan form into securities. But to participate in that market one must be able to underwrite securities.

So the key is to remove any artificial restraints and if this securitization of loans continued it could very well be that the direct lending activities of banks could severely diminish.

Senator GORTON. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. I just have one question for Mr. Connell. Mr. Connell, I'm happy to see you. You are certainly a highly respected former regulator. You did a great job with the credit unions and we are grateful to you for that. They are very important in our State. As you know, their international headquarters is in Madison.

Mr. Connell, should the Congress mandate thrift institutions to achieve capital adequacy according to generally accepted accounting standards by a day certain or be merged out of existence?

UNIFORMITY OF STANDARDS

Mr. CONNELL. Senator, I'm a believer that the capital standards and the regulatory standards should be much more uniform than they are today.

The accounting standards that exist in the thrift industry are rather strange and have been designed to meet an extraordinary emergency and the emergency is not over yet. We are still working our way through the aftermath of regulation Q and what we paid for in regulation Q in limited operating powers.

I think over time, without question, the accounting standards should be consistent. I haven't got an exact date for it, but I would say that type of policy should be coupled with a more comprehensive policy, including the extension of the Net Worth Certificate Program and restructuring of the Net Worth Certificate Program for longer term credit.

I remember 20 years ago, as a young person in the Comptroller's Office, actually processing the last of the RFC certificates that were granted during the depression. The last one was paid off somewhere in the early 1960's. One of the old-time clerks said, "Oh, look at this thing." What that taught me during these last couple years is that that program succeeded in helping the banking industry through its difficult time.

The savings and loan industry is still in a difficult time. Things are a little better right now, but there are a lot of them out there that are still struggling and they need continued assistance in

terms of the Federal insurance funds to provide I think the bridge to continued existence.

Senator PROXMIRE. Would you say that 5 to 7 years would be a reasonable period perhaps for them to achieve capital adequacy programs in terms of generally accepted accounting principles?

Mr. CONNELL. I would say 5 to 7 years is a reasonable horizon, but it should be coupled with the Net Worth Certificate Program so that there's room there to reach these numbers and that is because the numbers themselves cause a public response that has to be handled very, very carefully.

Senator PROXMIRE. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate your willingness to be here today.

[Response to written questions of Senator Garn from C. Lawrence Evans, Jr., and Lawrence Connell follow:]

*Exhibits mentioned in Lawrence Connell's response to written questions of Senator Garn can be found in the Senate Banking Committee's files or from:

Exhibit A-2: Journal of Insurance Regulation or from author, Joanne M. Derrig, Assistant Counsel at Allstate Life Insurance Co., Northbrook, IL.

Exhibit A-3: Code of Federal Regulations, 12 CFR 337.4 para. 47,848.

Exhibit A-4: Code of Federal Regulations, 23 CFR 332.7 (proposed—50 F.R. 23964—June 7, 1985).

Exhibit B: Murphey Favre Supervisory Procedures Manual.

Exhibit C: Federal Reserve Bank of Chicago.

Exhibit D: Bankers Magazine, vol. 159, winter, 1976, pp. 109-12, also paper entitled "An Economic Prospective on Bank Uniqueness and Corporate Securities Activities," Federal Reserve Bank of Chicago, 1984, pp. 199-201.

ANSWERS OF C. LAWRENCE EVANS, JR. TO
QUESTIONS FROM SENATOR GARN

Question 1

You indicate that many insurers may not be able to survive if they are restricted to their narrow markets. Could you explain how they will be disadvantaged? Do other firms agree with your analysis? Privately? Publicly?

Response

Many life insurers can not survive as viable business entities if they are restricted to selling only life insurance products. Traditional products like whole life insurance simply are not selling well in today's environment. The marketplace has changed dramatically. Consumers now have begun to demand investment-oriented products with a high rate of return in addition to pure insurance protection. They also want to purchase a variety of financial services in addition to insurance. People also are seeking more highly trained financial advisors to help them select which products best suit their individual needs.

To meet today's consumers needs, life insurers must not only diversify their financial service product offerings, but they also must make revolutionary changes in the way products are marketed. The insurance agency system, which historically has been the primary means of selling life insurance products in effect must be "retooled" to become much more efficient. Most life insurance agents have begun to find that they can not make an

adequate living by selling only life insurance products. This fact alone will become a powerful driving force behind life insurers becoming diversified financial service organizations. Let me explain why.

In the past, life insurance companies offered only a narrow range of products that generally were sold through the agency system. These products, such as whole life insurance and deferred annuities, had only limited investment elements and faced no real competition from non-insurance products. Consistent with the times, they carried high front-end loading charges and offered relatively low interest rates on cash value accumulations. This pricing and return structure enabled the insurer to pay the sales agent a sizeable commission and still have a reasonable return. While agents had to make many calls to make a single sale, and therefore necessarily could make only a relatively few sales, the commission levels on those few sales were high enough to provide the agent with an adequate personal income.

Today, agents are finding that since more and more consumers want better values traditional whole life insurance simply is not selling well. People want to buy newer insurance products like universal life, which offers better investment return potential, and flexible premium products that are registered as securities.

The only way life insurance companies can offer such products at prices that can compete with similar "investment" products offered by securities firms and other financial institu-

tions is to lower significantly both administrative costs and agents' commissions. For agents, this loss of commission income presents serious problems that simply can not be offset by selling more life insurance. They already sell as much as they can.

Acacia recognized far earlier than most life insurers that diversification into other financial services is the key for a company and its agency force to survive and prosper in today's marketplace. We saw that we had to sell more types of financial products through our agency system. Fortunately, it also was apparent that this could be done. Acacia's agents had a natural client market for both insurance and non-insurance investments and other financial products.

By diversifying into other financial products in addition to insurance to meet consumers varying needs, we could offer agents the opportunity to earn additional income to make up for today's lower commission rates on insurance products. Thus, although Acacia's agents now earn smaller commissions on each product, the total fees earned from selling our array of financial products can provide agents a very adequate level of income. For example, in addition to selling newer insurance products like universal life, our agents are selling securities products through their affiliation with our Calvert Securities subsidiary. In essence, we are simply being far more efficient by distributing many more products through our agency system. This means, of course, that our agents have had to "retool" and become more highly trained financial advisors.

More and more life insurers are having to follow the pioneering diversification course already taken by Acacia and some other traditional life insurers. Companies are rapidly shifting their insurance products to offer universal life and flexible premium products. There also is a growing trend to diversify by owning non-insurance financial service companies such as securities firms, and banks or thrifts. Many life insurers also have diversified by owning companies that offer other types of insurance and pension products. In addition, more companies are engaging in direct marketing to lower distribution costs, and many are seeking to market insurance products through depository institutions.

In the very near future, a major insurance association is scheduled to release findings from an industry-wide study that will show virtually all large insurance companies have diversified. Diversification is not confined to only the giants of the industry as shown by the actions of a number of smaller companies like Acacia. It is implicit that these insurance companies believe that diversification is the key to being able to compete in today's financial services market.

I also can attest that many companies who earlier argued for maintaining the traditional wall between life insurance and other financial services now suddenly are asking us privately to advise them on how they too can diversify. Even the traditional industry stalwarts are reconsidering their mix of products.

Congress also should recognize that some life insurance companies that privately acknowledge that diversification is essential nevertheless publicly still are stating that the traditional walls between the financial service industries should be maintained. Why? By stalling change through political actions for several years, such companies hope to have time to revamp their own products and distribution systems so that they can compete more easily. If change were allowed to come as quickly as the market otherwise would dictate, these companies, which were slower than Acacia in recognizing the marketplace changes, fear they would be competitively disadvantaged. By delaying change through the political process, they gain time to diversify.

We understand that some companies also are taking similar stopgap measures in the marketplace. A number of companies are drawing down their huge reserves and/or using short term tax savings that resulted from the 1984 tax law revisions to keep the price of their insurance products artificially low and in effect to supplement agents' incomes while they are preparing to diversify. Thus, they literally are buying time to change.

Another interesting phenomenon that apparently exists is that some large companies already are so diversified that they now are able to compete effectively with other types of financial service firms. Therefore, they may be quite content for now with merely grandfathering their status since it gives them tremendous competitive advantage.

The Congress therefore must not be confused or misled by some current political or marketplace posturing. In reality, the marketplace has changed and life insurance companies and their agency forces have no choice but to diversify their sales if they want to survive.

Question 2

Do you think it would be advisable for the Congress to explicitly authorize joint ventures between these "merging industries?" What kind?

Response

We believe that removing the artificial political walls between insurance, banking and securities will best serve the interests of the Nation. Congressional approval of joint ventures would only be a partial step that helps remove outdated federal and state regulations that limit competition and that threaten the survival of companies like Acacia.

Many companies already engage in some type of joint marketing arrangements. However, a wider range of permitted activities would provide an efficient means of distributing insurance products and should generate significant fee income to improve banks' and thrifts' safety and soundness.

Likewise, sales of bank products by insurance agents present no undue risks to the banking system and do offer another opportunity for the bank to increase its earnings while providing the insurer and the agent a small fee. The principal advantage for the insurer, however, is to be able to provide a wider array

of financial products that best suit the needs and objectives of individual clients.

Recognition of the propriety of the affiliation of financial service companies also would provide national uniformity as to what activities are permitted between the various financial services industries. Presently, certain state laws are being arbitrarily interpreted as prohibiting certain affiliations. These state restrictions have undue extraterritorial effects that render a hardship on companies that are compelled by the market to diversify. Such state laws disadvantage those companies who conduct business in such states. Congress' approval of specific affiliations would bring us closer to a more level playing field by preempting these outdated state laws.

Question 3

How do you manage potential conflicts of interest between your various components?

Response

A plethora of statutes and regulations prevent conflicts of interest between our affiliates. For example, since Acacia Mutual owns Acacia Federal Savings Bank, it is a federal savings and loan holding company. As such, federal law prohibits various improper transactions between affiliates. Thus, Acacia Federal Savings Bank is prohibited from investing any of its funds in stocks, bonds, debentures, notes or other obligations of any affiliate and it may not accept such items from any affiliate as collateral security for any loan or extension of credit. Such

prohibitions insulate Acacia Federal Savings from risks associated with investing in an affiliated company. Savings and loan holding company laws also regulate, through the Bank Board, Acacia Mutual's acquisitions, activities, and investment standards. We also are subject to periodic announced and unannounced Federal Home Loan Bank Board examinations.

Acacia Mutual is also an insurance holding company which is regulated by state insurance commissioners who actively seek to prevent any improper conflicts of interest. We are required to report all material changes in our corporate structure or investment portfolio annually. Tax laws also require that any dealings between affiliates are conducted at an arm's length. The Securities and Exchange Commission and the National Association of Securities Dealers also periodically review our records to assure there are no conflicts of interest. Both bank and securities laws require our investment management company and our savings bank to have a majority of their boards to be outside directors. The directors also help assure no conflicts occur.

Our internal auditors, as well as our legal and financial personnel constantly are watching for potential conflicts. Independent auditors annually review our records for similar problems.

Thus, we have a wide range of safeguards to prevent conflicts of interest.

Question 4

In your testimony, you indicated that an inability to provide for a variety of needs can cause conflicts. Will you elaborate?

Response

Individuals have a variety of needs, ranging from life insurance protection to satisfying investment objectives, and most individuals have only a certain level of resources available to pay for these needs. If an insurance agent can only satisfy one of those needs -- life insurance -- and if he makes his living only by selling this one financial product -- then he naturally will be inclined to sell as much insurance as he can persuade the client to purchase. However, insurance often may not be what the individual needs. The agent has an inherent conflict of interest because he must recommend insurance in order to receive a commission. Otherwise, he receives nothing.

If, on the other hand, the agent can sell a variety of financial products then he can recommend a mix that best suits the client's needs. The individual can optimize his limited resources and satisfy a variety of needs when diversified products are offered by his or her financial advisor. No conflict of interest necessarily exists when the advisor can offer a full range of products because the advisor can earn as much or more money on the sale of a variety of products as he could by selling just life insurance. In the end, the consumer is benefited by being encouraged to acquire appropriate financial products.

Congress must recognize that the same type of conflict arises with other marketers offering only a limited range of financial products. A stock broker, for example, who can only offer investment products would be inclined to recommend a consumer purchase such products even in situations where the consumer's needs would be best met by a mix of insurance protection and financial products.

Question 5

Please provide concrete examples of problems Acacia has experienced in trying to expand into new portions of the financial services industry.

Response

Our expansion into new areas of the financial services industry has been like going through a maze and running into concrete barriers after each turn. Dealing with the plethora of required regulatory approvals at every step during our expansion has been difficult and expensive but our principal problems have been the arbitrary and unreasonable restrictions placed by federal and state law on our activities.

First, and foremost, is the prohibition on Acacia Federal Savings Bank from branching into other states. Interstate banking operations would complement our other financial services in many ways and would allow Acacia to better serve its clients.

Second, the Bank Board has prohibited our investment management subsidiary, Calvert Group, Ltd., from securities underwriting or marketmaking.

Third, unnecessary inconsistencies of federal and state reporting requirements for our various components also create an ongoing problem. The SEC, the NASD, the Bank Board, and state insurance commissions all require disclosures and financial statements from Acacia Mutual and its relevant subsidiaries. These differing reporting requirements generally require unwarranted duplicative efforts.

Fourth, when Acacia decided to diversify into banking operations, we found that while insurance companies and securities firms can operate in every state, banks and thrifts still are subject to outdated interstate branching restrictions. We rejected the idea of acquiring a "non-bank bank" to avoid such limitations because we felt their time was limited and we thought Congress would soon authorize branching.

We found that a thrift institution offered the best available overall flexibility for our needs. We were limited, however, to the acquisition of a single thrift since ownership of multiple thrifts would prohibit our sale of insurance. Now, we face the prospect of prohibitions on cross-marketing of products between our savings bank and our other operations due to legislation recently approved by the House Banking Committee.

State laws often pose even greater restrictions on diversification of an insurer's financial services operations. Direct entry into banking and securities is typically prohibited. Whether an insurer can enter banking and securities indirectly through subsidiaries or affiliations depends largely on deter-

minations made by its state insurance commissioner. Typically, this would be allowed only if the insurance commissioner finds that it is reasonably ancillary to, or incidental to, any insurance business. These findings are by no means guaranteed. Additionally, state and federal holding company laws present severe obstacles to an insurer's formation or acquisition of subsidiary corporations.

Question 6

What role does diversification play in the effort to lower delivery cost? If distribution costs were lowered, would fewer Americans be under-insured? How would the consumer benefit?

Response

Diversification is the key to lowering delivery cost. As I explained in my oral testimony and in my answer to Question 1, the traditional life insurance agency distribution system simply is too inefficient in today's marketplace. Consumers are demanding more investment returns, and insurers are being forced to reduce both administrative costs and agents' sales commissions. You can imagine how lowering agents' commissions places a severe strain on the agency system. Agents who have been working very hard to make enough sales to earn an adequate income, now find themselves faced with significantly lower commissions.

While many agents and some companies still dream of the return of the by-gone days of insurance Camelot when consumers bought whole life policies and the agents received hefty commissions, Acacia was quick to focus its dreams on the future and to

turn the company and its agency system into a new, competitive financial services organization.

If an agent can sell more than one product to his client, as well as earn a fee for other financial services, then the delivery cost for each product can be reduced greatly. Diversification very simply offers economies of scale in the sale of financial service products. Basically, the agent can make more sales for the same effort when he also can offer an array of investment products and services.

Diversification also should lower the cost of all financial products, since a separate distribution system is not necessary for each. A single network can offer insurance, securities, and banking products. Unnecessary duplication of distribution systems only wastes this country's resources.

With lower distribution costs and therefore more competitively priced insurance products, more American families could afford insurance protection. When asked, most Americans desire life insurance protection. It is axiomatic that if the purchase price of insurance can be kept down because of diversification, then fewer Americans would be underinsured. More could afford to purchase insurance for the first time and others would be able to acquire more adequate insurance coverage to meet their needs. The consumer also benefits from having his or her individual financial services needs met.

Diversification ameliorates the conflict of interest I described in my answer to Question 3. The consumer is protected

from a "hard sale" of solely insurance when his or her advisor can offer an array of products that would better suit the individual's needs.

Finally, there is another compelling justification for diversification. As I indicated, life insurance companies simply cannot survive without diversification. If they are denied this opportunity, I am convinced that many insurers will be business failures. This will have a very adverse impact on the nation's financial system. Congress and state officials already have had great difficulty dealing with failing thrift and banking institutions. The same type crisis could develop in the life insurance industry unless diversification is allowed. State insurance guaranty funds simply are inadequate to meet these potential losses. If Congress does not act to allow diversification, it must be prepared to deal with subsequent requests to bail out failing insurers.

July 23, 1985

Responses by Mr. Connell to Questions Posed by Senator Garn

1a. Some have suggested that in 1981 thrifts were suffering from a lack of flexibility. Now with additional flexibility the well-managed are getting stronger but the weak are misusing their new powers. Do we face a shortage of prudent management?

We should not face a shortage of prudent management. In my mind prudence and fiduciary responsibility in banking are nothing more mysterious than traditional sound banking practices: limitation of leverage, diversification of risk, sound credit analysis. If supervision does not uphold and enforce these practices, then a marginally larger number of managers will be tempted to engage in imprudent -- that is, reckless or negligent -- activity. Prudence is thus a result of the interplay of legal enforcement and traditional standards of conduct. The flexibility advocated in our testimony is entirely compatible with prudence. Flexibility should not be confused with laxity or license.

The question also suggests a concern that there may be too few depository institution managers trained to manage institutions engaging in a wide array of activities. It is of course true that periods of transition test the mettle of those in positions of responsibility and that some will perform better than others. It is also true that until the late 1970's, many thrift institutions engaged only in a relatively narrow range of activities that did not require wide-ranging management skills. But the powers and needs of thrift institutions have changed; old management has developed new skills, and new talent has been attracted to the industry. It is the responsibility of senior management initially and the regulators ultimately to determine whether an institution's management possesses the character and skills required to develop and carry out a sound and prudent business plan. Through thorough examinations, oversight and periodic reporting the regulatory agencies should monitor each institution's condition and take remedial action -- including requiring replacement of management personnel, as discussed in our response to Question 6 below -- if an institution's performance is substandard. A concern about managerial competence is no argument against broader powers and greater flexibility for depository institutions.

1b. How can or should a regulator measure an institution's ability to take on new products or geographic markets? What criteria should they use?

There ought to be a presumption that no prior regulatory approval is necessary before an institution can expand into new markets. The overwhelming majority of institutions, whose examination reports indicate sound performance (based upon proven management, adequate internal controls, solid financial condition, etc.), should have the legal flexibility to design and modify a business plan within the strictures of state and federal law that calls for expansion and diversification without the encumbrance of regulatory action. The powers and flexibility of institutions should not be determined on a lowest common denominator basis -- that is, with reference to those whose performance is substandard.

An institution that has not been performing well should be operating under a business plan developed in close coordination with its regulators, and whether that plan should call for diversification should be determined on a case-by-case basis. Regulators of course must have the power and resources to supervise, get adequate information in order to monitor performance, and to impose appropriate restrictions on those whose performance is substandard.

If the Congress nevertheless determined that a threshold regulatory review is necessary before an institution entered nontraditional lines of business, then a prior notice procedure might be considered. Under such a procedure, the banking organization would provide notice that it intended to commence an activity, would summarize its business plan, and provide information about the proposed capitalization, management, organization of the activity and other traditional banking factors. Based upon that information and the results of the organization's recent examination reports, the agency would allow the commencement of the activity unless the organization's past performance, capital, proposed management, or business plan were clearly deficient. This is a procedure similar to that used by the Comptroller of the Currency for national banks seeking to exercise trust powers.

2. How can we "supervise" the control of potential conflicts of interest if we permit the flexibility you ask us to maintain

(particularly as it relates to securities activities)?

The issue of potential conflicts of interest has been a stalking horse put forth by representatives of industries that fear competition from banks, and in spite of the fact that a number of securities, insurance and commercial firms already combine insurance, securities and banking activities. In addition, those who raise the conflicts of interest issue ignore the fact that combinations of activities other than banking also produce potential conflicts of interest. Securities firms engage in both retail brokerage-investment advisor business and underwriting. Insurance companies engage in commercial lending and manage investment portfolios. There is nothing inherently wrong with the combinations of financial services activities in one organization or the legal flexibility to do so. Moreover, there is no evidence that existing combinations are producing conflict of interest situations that cannot be dealt adequately with under existing law.

Our experience at Washington Mutual supports this conclusion. Washington Mutual has operated a full-service regional brokerage subsidiary and insurance underwriting and brokerage subsidiaries for several years. We believe that the record supports our view that such affiliations may exist and their activities may be coordinated without producing conflicts of interest. Washington Mutual has developed operational standards and procedures that are based upon both the law and our view of responsible and prudent management to ensure proper conduct by our employees. Illustrative of our approach is an extract from our Supervisory Procedures manual, attached hereto as Exhibit B.

Insured depository institutions, securities firms, and insurance companies each are governed already by statutes and regulations that deal with potential conflicts of interest arising from affiliations. These provisions tend to be parallel and mutually reinforcing. The state and federal regulators who administer these provisions therefore already have ample authority to prevent abuses arising from conflicts of interest and to punish firms that nevertheless engage in such conduct. The possibility of abusive affiliate transactions and self-dealing are principal concerns expressed by those who question the desirability of deregulation. The remainder of this response will review existing law in these areas.

Federal banking and savings and loan law and state insurance laws contain detailed provisions governing transactions involving affiliates within a holding company

system. These provisions are intended to prevent the assets of an insured bank or thrift, on the one hand, or an insurer on the other, from being used for the benefit of an affiliate. A comparative chart (Exhibit A-1) summarizes the provisions of the Federal Reserve Act ("FRA"), the Savings and Loan Holding Company Act ("SLHCA"), and the National Association of Insurance Commissioners Model Insurance Holding Company System Regulatory Act ("NAIC Model Act"). The FRA and Model Act provisions are also compared in a recent article, Derrig, "Regulating Transactions Between Affiliates: A Comparison of the NAIC Model Insurance Holding Company Law with its Federal Banking Law Counterparts," 3 Journal of Insurance Regulation 444 (1985) (attached hereto as Exhibit A-2). In addition, the federal securities laws supplement the common law governing fiduciaries and provide a comprehensive regulatory scheme for mutual funds and investment advisers. Another detailed federal statute, the Employee Retirement Income Security Act (ERISA), governs the conduct of managers and trustees of pension funds and other retirement assets held under its provisions.

Savings and Loan Organizations. The provisions of Section 408(d) of the SLHCA, 12 U.S.C. § 1730a(d), are quite comprehensive -- they prohibit the S&L subsidiary of a holding company from investing in or extending credit to any holding company affiliate and effectively require Federal Savings and Loan Insurance Corporation ("FSLIC") prior approval for any transaction involving any purchase, sale, or lease of property or assets or any agreement for the rendering of services by an affiliate for the insured institution. See also 12 C.F.R. § 584.3.

Banking Organizations. Section 23A of the FRA, 12 U.S.C. § 371c, governs affiliate transactions involving federally insured banks. It places stringent limitations on extensions of credit by such banks to affiliates and on their purchases of assets from affiliates. The bank may engage in such "covered transactions" (specified extensions of credit or asset transactions) with any one affiliate only to the extent of 10% of the bank's capital and surplus and with all affiliates only up to 20% of its capital and surplus. Moreover, all covered transactions must be collateralized at least to the full amount of the extension of credit.

Further, Section 23A prohibits the bank outright from purchasing a low-quality asset from an affiliate. See 12 U.S.C. § 371c(a)(3). This would prevent a bank from buying uncollectible receivables or similar distressed property from an affiliate. In addition, the Federal Reserve Board has ruled that it would be a violation of Section 23A, subjecting bank employees to civil money penalties, if a bank purchased an

asset from an affiliate at more than its fair market value. See [1973-1978] Fed. Banking Law Rep. (CCH) ¶ 96,715.

Section 23A also restricts lending transactions between a bank and non-affiliates, to the extent that the proceeds of any such transaction are used for the benefit of an affiliate of the bank. See 12 U.S.C. § 371c(a)(2). All such transactions would have to be collateralized to the same extent as loans to affiliates, 12 U.S.C. § 371c(c), even when the transaction is at arm's length. See OCC Interpretive Letter No. 195, [1981-1982] Fed. Banking Law Rep. (CCH) ¶ 85,276.

For state nonmember banks, moreover, the FDIC has adopted a regulation specifically governing the relationship between an insured state nonmember bank and a subsidiary or affiliate engaged in securities underwriting or dealing. See 12 C.F.R. § 337.4. Among the detailed provisions of this regulation is a subsection concerning conflicts of interest. These restrictions are set forth in Exhibit A-3. Although parts of this regulation have been questioned as beyond the FDIC's authority, we do believe that the portion of the regulation concerning conflicts of interest is appropriate. An additional regulation, which is still under consideration, would govern an affiliation between an insured bank and an insurance underwriter and also contains conflict of interest provisions. See Proposed Regulation, 50 Fed. Reg. 23964 (June 7, 1985), to be codified at 12 C.F.R. § 332.7. (Exhibit A-4).

Additional affiliate transactions provisions have been proposed in connection with deregulatory legislation. In particular, S. 2851 included a new Section 23B of the FRA (originally proposed as part of the Administration's Financial Institutions Deregulation Act ("FIDA")), which would subject a much wider range of transactions between a bank and affiliates engaged in nonbanking activities to federal standards. It would generally require arms' length dealings between affiliates in connection with transactions that are not subject to the limitations of Section 23A, such as contracts or agreements not involving transfers of assets or extensions of credit. New Section 23B would also prohibit a bank or its subsidiaries from purchasing any security underwritten by an affiliate during the time that the underwriting and distribution syndicate was in existence.

Insurance Companies. The NAIC Model Act contains parallel provisions designed to prevent an insurance holding company system from tapping insurance company assets for the benefit of affiliates and to the detriment of policyholders. The Model Act also imposes strict requirements for prior regulatory approval of payment of extraordinary dividends by an

insurer to its parent or affiliates and requires full disclosure of all ordinary dividends and material transactions. These provisions are broader in scope and application than the banking and S&L affiliate transaction provisions. See generally Derrig, supra (Exhibit A-2.)

Securities Industry. Four statutes enacted during the New Deal established a framework of regulation of firms and individuals engaged in the securities business. Both the Securities Act of 1933, which governs issuers and underwriters, and the Securities Exchange Act of 1934, which governs securities markets and broker-dealers, contain broad anti-fraud provisions intended to insure that the public have all material information about securities and their issuers and to prevent those engaged in the issuance, underwriting, sale or dealing in securities from using their position for possible advantage.

The Investment Company act of 1940 ("1940 Act") and the Investment Advisers Act of 1940 govern mutual fund activities. They supplement traditional common law governing the duty or loyalty of a fiduciary, in this case a manager of or adviser to a mutual fund. Section 17 of the 1940 Act, 15 U.S.C. § 80a-17, and Section 206 of the Advisers Act, 15 U.S.C. § 80b-6, set forth these statutory duties. These detailed provisions, in brief, provide that investment advisers to investment companies may not sell to, nor purchase or borrow from, the investment company that employs them, unless a specific exemption is received from the Securities and Exchange Commission. See generally T. Frankel, The Regulation of Money Managers (1978), especially chapters 12 & 13.

Finally, the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa et seq., governs issuance of debt securities pursuant to a trust indenture. It contains detailed provisions governing the conduct of the indenture trustee, including requirements that the trustee be free of conflicting interests and adhere to high standards of conduct and responsibility.

Retirement Assets. Because of the increased significance of pension and retirement assets (including Individual Retirement Accounts), many banks, securities firms and insurance companies now serve as fiduciaries under ERISA, a comprehensive statute that contains conflict of interest provisions. ERISA prohibits a fiduciary from acting in any transaction involving a retirement plan on behalf of (or representing) an adverse party. In addition, ERISA bars a fiduciary from engaging in any transaction which constitutes a direct or indirect (1) sale or exchange, or leasing, (2) lending of money or extension of credit, (3) furnishing of goods, services or facilities between the trust and a

party-in-interest, as well as any transfer to, use by, or for the benefit of a party-in-interest of trust assets.

3. In your testimony, you advocated setting aggregate and single issuer limitations to underwriting of a securities subsidiary. What levels would you recommend? Should the regulators have the authority to decrease these percentages?

Any new standards governing securities underwriting activities that are made applicable only to subsidiaries of depository institutions should be developed with several points in mind. First, such limitations presumably would have the purpose of limiting the risk to the bank or S&L arising from the activities of the subsidiary. The specific nature of this risk to the institution must be analyzed as the predicate for any new provisions. It is our experience with our Murphy-Favre subsidiary that the risks and liabilities associated with its activities are no greater than those associated with our traditional banking activities. Moreover, studies have found that securities underwriting is no riskier than commercial lending. See Saunders, Abstract of a paper entitled, "An Economic Perspective on Bank Uniqueness and Corporate Securities Activities," Conference On Bank Structure and Competition (Federal Reserve Bank of Chicago, 1984) and Heggstad "Diversification, Risk and the Bank Holding Company," The Bankers Magazine (Win. 1976) 109-112. (Attached as Exhibit D). In this connection, I would also stress a point made in my testimony. A brokerage firm participant in the distribution network in a securities underwriting should not be regarded as an "underwriter" for purposes of provisions dealing with a bank securities firm affiliation. A selling broker does not bear the same kind of risk as a principal underwriter.

Second, the federal securities laws and regulations already contain provisions designed to promote the solvency of broker-dealers, which are of course based upon the Securities and Exchange Commission's (SEC) assessment of the risks involved. Security dealers that are regulated and examined by the SEC and National Association of Securities Dealers, Inc. ("NASD") are subject to rules limiting the aggregate obligations that a dealer can incur, including obligations incurred in the course of underwriting. SEC rules 15c.3-1 and 15c.3-3 are specifically designed to ensure the safety and soundness of broker dealers. These rules already apply to all registered and licensed broker-dealers, including Washington Mutual's brokerage subsidiary.

Because the soundness and conduct of registered broker-dealers is the primary responsibility of those agencies, additional statutory requirements that would apply only to certain broker-dealers (i.e., those which are also bank subsidiaries) and that could place those broker-dealers at a competitive disadvantage should be adopted only if a banking objective, such as safety and soundness, would be demonstrably furthered. Indeed, the FDIC has adopted a rule that has that objective. It seeks to limit the risk to an insured bank from its investment in a securities subsidiary by requiring it to be a "bona fide subsidiary" that operates independent of the bank, is adequately capitalized, and is not an alter ego of the bank for purposes of maintaining the bank's limited liability as a shareholder of the securities firm. See 12 C.F.R. § 337.4. This rule contains a number of excessively restrictive and burdensome provisions and goes beyond any regulation that may be necessary. Even so, it does not include any aggregate or single issuer limitation on underwriting.

Moreover, earlier this month the SEC adopted a rule to ensure that all bank securities activities are clearly subject to its jurisdiction. This new rule requires that all bank securities activities be carried out by separate subsidiaries, subject to SEC capital requirements. The July 2, 1985, Wall Street Journal reported that the American Bankers Association objects to this rule, and the ABA representative complained in that article about the SEC's high capital requirement. These SEC rules are quite stringent about the exclusion of unmarketable securities from net capital and the requirement to mark securities to market. Indeed, this portion of the rules applicable to the brokerage subsidiaries of banks is more stringent than the rules applicable to the loan and bond portfolios of the banks themselves.

Third, existing banking law and regulations have the purpose of ensuring the safety and soundness of insured banks and provide bank regulators with wide-ranging powers. Through use of their traditional mechanisms of examination and supervision, the FDIC and the Comptroller of the Currency presently have ample authority to supervise not only the activities of the parent bank but also the activities of any bank, subsidiary or affiliate, including a securities subsidiary. (See our discussion of the agencies' powers vis-a-vis affiliates in our response to Question 4, below). The activities of the securities subsidiary can be guided via the regulatory agency's policies, and the agency can require the securities subsidiary to provide it with business plans implementing those policies. Upon examination of the bank and its securities subsidiary, the agency can monitor the subsidiary's performance pursuant to the business plans, and can provide suggestions as to appropriate staffing, procedures

for evaluating investments, and the propriety of particular activities. In addition, the agency's safety and soundness powers ensure that through existing formal and informal capital requirements an adequate level of capital will be present at both the parent and subsidiary levels. Finally, the agency's cease-and-desist powers, while seldom exercised, allow the agency to enforce supervisory policies. The cease-and-desist powers, as a practical matter, give the agency total control over subsidiary activity, even if no formal notice of such activity to the agency is required.

In light of this existing body of law and practice, special limitations on the securities underwriting activities of a bank subsidiary should not be necessary. Existing limitations should be adequate. If the Congress nevertheless determines that new provisions are required, it would be appropriate to look to bank lending limits and the considerations underlying those limits.

If a single issuer limitation were imposed, it should be the same as the traditional bank lending limit of 10 percent of capital and surplus to any one obligor. That is a guideline that has proven its worth. With respect to aggregate limits, fifty percent of capital and surplus would be a reasonable starting point, until the industry has demonstrated its ability to handle this new type of risk.

Regulators should have the authority to decrease or increase those aggregate percentage of investment levels as conditions and experience warrant. Indeed, we prefer giving the regulator relatively broad power on investment limitations because it removes the issue from the political arena. As a state regulator and manager of a state chartered bank, I observed the lobbying battles that took place when savings banks sought to expand their consumer lending powers. Although no real issue of safety and soundness was involved, the commercial banking industry regularly opposed expansion of those limits for competitive reasons. Similar turf battles also characterize the debate over securities and insurance activities for depository institutions.

4. Do you believe securities firms and insurance companies should be authorized to own banks? Please explain. How would you regulate them?

As our testimony and answers to these questions indicate, we believe that financial institutions should not be restrained by law from engaging in any financial activity. A

well-managed financial organization should have the flexibility to determine the mix of products and services that is best suited for its market and its position in that market. Combinations of banking, insurance, and securities firms should therefore be authorized. If such a change in the law is not made, present law should not be altered, because it provides opportunities for such combinations by at least some organizations. We would therefore oppose amendments to the Bank Holding Company Act or Glass-Steagall Act that would make these statutes more restrictive.

There are fundamental reasons for removing all barriers to combinations. As stated in our testimony, fundamental changes in the economy, technology, and consumer preferences have effectively eroded whatever rationale may have once existed for artificial legal barriers between banks and securities firms and insurance companies. Combinations of entities engaged in those activities therefore should be authorized.

Changes in the economy and in the marketplace have undermined and are continuing to undermine the longrun viability of depository institutions that are required by law to limit their activities. The plight of the thrift industry is obvious and ongoing and cannot be remedied as long as thrifts are required to specialize in home mortgage lending. The housing market has always been cyclical. Interest rates have become more volatile. The demand for new housing varies dramatically from one region to another. Competition in mortgage lending has increased, especially from sophisticated new entrants that combine computerized loan originations with funding generated in the mortgage securities markets. Moreover, savings and loans need the resources available outside that industry in order to be strong and competitive. The law should not stand in the way of such acquisitions. Indeed, I would much rather have a troubled thrift purchased by an established insurance, retailing or investment banking company than by a real estate speculator.

Although the banking industry has not suffered like the thrifts have, the long-term viability of banking organizations confined to a relatively fixed portion of the expanding financial services industry should be a matter of genuine concern. The testimony of James McCormick before this Committee on May 22, 1985, demonstrates the bank's weakening competitive position. Noting that commercial banks can no longer compete with securities firms in offering low-cost financing services to the most creditworthy business customers, Mr. McCormick predicted that commercial banks will have to "shift their focus from asset and deposit growth to a form of intermediation that requires less equity, and is therefore

delivered at lower cost to the customer." Then Mr. McCormick continued:

We feel that legislators' primary focus should be on facilitating the transition and minimizing disruptions, from the public's perspective -- both consumers and corporations. We believe that this will require elimination of constraints that preclude banks from evolving into more efficient intermediaries. Failure to provide relief will relegate banks to an outmoded method of competition and will likely lead some banks to take greater risks causing further bankruptcies, threats to public confidence, and drains on FDIC reserves.

An indicator of the erosion of banks' competitive position is the proliferation of substitute products offered by nonbanking companies. Money market mutual funds can offer interest paying transaction accounts that are virtually free of risk; securities firms offer businesses short-term, risk-free cash management through use of repurchase agreements; thousands of consumer loan companies, retailers, mortgage bankers and thrift institutions offer one or another form of consumer lending; and thousands of insurance companies, securities firms and commercial credit lenders offer financing services that, to the business customer, are either indistinguishable from bank services or superior in terms of cost or convenience.

The development of these alternatives is indicative of a second major reason for removing restrictions on combinations of depository institutions with securities and insurance firms. Changes in the economy, technology and consumer preferences have revolutionized the financial services industry. We discussed these changes in our testimony, and our answer to Question 8 (concerning the blurring of product and service lines) also reviews changes that have occurred and consumer benefits that have resulted.

If the law is changed to open the way to cross-industry combinations, significant changes in the present regulatory structure may not be necessary. As the responses to Questions 2 and 3 indicate, the issues raised by such combinations are largely dealt with under present law. Questions of safety and soundness, anticompetitive behavior, conflicts of interests, tying, consumer protection, and so forth are already covered in the existing bodies of law governing depository institutions, securities firms, and insurance companies. The companies that already own a firm

engaged in each of these lines of business are subject to effective regulation under present law. Moreover, existing banking laws give federal agencies sufficient authority to police both what persons or firms take control of a depository institution and the ongoing relationship between the institution and its affiliates.

Existing law governing the acquisition and control of federally insured depository institutions provides ample authority to ensure that a securities, insurance or other company that acquires or becomes affiliated with a federally insured depository institution will be sound and responsible. The federal Change in Bank Control Act, 12 U.S.C. § 1817(j), which was enacted in 1978, provides that no person or entity may acquire an insured bank until the appropriate federal banking regulator has made a full review of the financial and managerial resources and character of the acquiror and determined that the acquisition would not be adverse to the interests of the bank and its depositors. That Act also requires the regulator to determine whether the acquisition would have adverse effects on competition. A parallel statute governs change in control of federally insured savings and loan associations. See 12 U.S.C. § 1730(q). The Bank Holding Company Act of course also requires regulatory approval before any "company" acquires control of a "bank," as that Act defines those terms. See 12 U.S.C. §§ 1841(a), 1842. These provisions are sufficient to ensure that no one who is likely to abuse an institution will be permitted to control it.

Federal law also gives banking and S&L regulators the power to ensure that the ongoing relationship between an institution and its parent, subsidiaries and affiliates is consistent with safety and soundness. Each agency is empowered to examine affiliates of insured depository institutions "as shall be necessary to disclose fully the relation between such bank and such affiliates and the effect of such relations upon the affairs of such bank." 12 U.S.C. § 481 (national banks). Parallel provisions govern affiliates of insured state banks and insured savings institutions. See 12 U.S.C. §§ 334, 338 (state member banks); 1828(b) (state nonmember banks); 1730(m) (insured savings and loan associations). This authority appears adequate, but if it is determined to be insufficient to ensure that depository institution regulators can require an acquiror to provide all relevant information concerning the nonbanking affiliates of the bank, then amendments to supplement these provisions should be considered. Of course, if the number of institutions and affiliates subject to regulation increases, the staffs of existing regulatory agencies would need to be enlarged accordingly. As we

emphasized in our testimony, adequate supervision requires adequate agency staff and resources.

Moreover, there is no evidence that existing systems for the regulation of depository institutions, securities firms or insurance companies conflict in a consequential fashion or that the various regulators lack the tools necessary to achieve the goals of each's system of regulation when one organization controls entities engaged in these activities. A report prepared this year by the Subcommittee on Regulatory Conflicts of the Industry Advisory Committee to the National Association of Insurance Commissioners examined the systems of regulation of depository institutions and insurance companies to determine whether regulatory conflict occurs when one organization or entity engages in both banking and insurance activities, whether directly or through a separate subsidiary. That report concluded that as long as the insurance and banking activities were conducted in separate entities, significant regulatory conflict should not occur. It states:

In light of the extent and diversity of the relationships [that presently exist between banking institutions and insurance companies], the Subcommittee found that regulatory conflict has occurred to a surprisingly limited extent. [C]onflict has been notably absent when both banking and insurance underwriting are conducted in one organization. The incidence of conflicts arising from bank involvement in the sale of insurance has been only somewhat greater. This relative lack of conflict has been due in large part to the fact that banking and insurance regulators operate separately and typically are unfamiliar with both the other system of regulation and the nature of the regulated institution. Further, although the statutory frameworks, the regulatory traditions, and the nature of the respective businesses (as reflected, for example, in accounting) are different in a number of ways, the regulatory goals and methods of banking and insurance regulators are parallel and should be mutually reinforcing. Finally, major solvency issues involving an organization conducting both banking and insurance underwriting activities have been rare. Frictions have occurred between state insurance commissioners and federal agencies, but conflict, as defined herein, between

insurance and banking regulators has been infrequent.

As the foregoing suggests, an overall federal regulator of financial companies may not be necessary. Existing state and federal regulatory agencies appear to have adequate authority to manage a world in which all sizes and types of combinations of banking, insurance, and securities entities exist. If this authority proves to be incomplete, statutes drawn to fill identified gaps should be enacted. Experience may demonstrate in the future the need for a federal coordinator of financial services regulation. If so, a new mechanism to that end should be devised. The task should not be given to any present agency.

The Financial Institutions Deregulation Act ("FIDA") proposed in 1983 by the Treasury Department would have established the Federal Reserve Board as such an overall regulator of financial holding companies. We believe that such an approach should be rejected, both because it appears unnecessary and because it is unfairly asymmetrical. The Bank Holding Company Act was designed to separate commercial banks from certain types of "commerce", and the Federal Reserve Board has for forty years argued for a more complete isolation of banks from commercial firms. We believe that Congress should reject the Federal Reserve's outmoded view (which Congress has never adopted) and should instead embrace a policy of unrestricted affiliation. It would be inappropriate and unfair to impose the Bank Holding Company Act structure on nonbanking companies or to permit the Federal Reserve to serve as an overall federal regulator.

Experience under present law and regulation supports our conclusion that combinations of banking, securities, and insurance firms present no inherent hazards and that existing regulation is on the whole adequate. As you are aware, a number of significant combinations already exist because the restrictions imposed under present law are not absolute (and tend to restrict banking organizations, especially those including national banks, more than insurance or securities firms). Sears, Merrill Lynch, Prudential and American Express are the most notable examples of companies with major insurance and securities subsidiaries that also own banks. Present law is not satisfactory because it presents opportunities to some institutions, but denies them to others. If such giants are to be permitted to have subsidiaries engaged in all three activities, there is no sound policy reason to exclude anyone by force of law.

If present legal restrictions applicable to bank holding companies remain in place, or if they are tightened

with a grandfather as S. 2851 and H.R. 20 propose, then the large companies that have a headstart may be able to achieve a significant competitive advantage over smaller, regional firms and bank holding companies, which would be prohibited from establishing such combinations.

Despite its uneven application to banking and nonbanking companies, present law does provide a basis on which a transition to a deregulated system may take place. It permits experimentation with new forms that is healthy. The reasons for permitting at least this continued evolution under present law have been well set forth in a paper published by the Federal Reserve Board of Chicago. Referring to combinations between diversified financial services firms and nonbank banks as "hybrid" forms, the authors of this paper state:

[U]nless a compelling case can be made that the public is likely to be harmed by a proliferation of hybrid or mutant forms of banks, little or nothing is likely to be (or for that matter, should be) done to prevent this evolution, particularly if these hybrid organizational forms account for only a small portion of the total financial services industry. This response, or lack of response, is appropriate because the new hybrid banks may represent a needed marketplace reaction to external environmental developments such as changing technology, shifting consumer tastes, inflation, and other developments. The stifling of experimentation with new organizational forms (particularly those funded by private capital), could prevent an evolution toward new financial enterprises that might better serve the public interest. Hence, if the private sector is willing to finance a number of small pilot programs involving new forms of competition in financial services and none of these experiments in and of themselves seem to be detrimental to the public interest, little would be gained through interference. Also, if the hybrid organizational forms are inferior to the old forms, they will go by the wayside; if the hybrid forms are superior, they will eventually be emulated and become more the standard than the exception.

The ones that may lose from this experimentation are the present-day incumbent organizations that wish to provide financial services the way they were provided several decades ago. The greatest challenge for regulators is to resist the temptation to protect the vested interests of those firms they presently regulate from utilizing an organizational form that provides lower cost or more convenient services to its clientele. (Rosenblum and Pavel, "Financial Services in Transition: the Effects of Nonbank Competitors", Federal Reserve Bank of Chicago, 1984 (No. 84-1), p.36.) (Attached as Exhibit C)

5. What is your opinion of the Sears Family Bank proposal?

The proposal is an interesting public relations and political gambit, but the last thing the financial services business needs is a new type of specialized charter. What is needed is greater flexibility to design business consistent with marketplace demands and developments -- not a new type of constrained entity. Moreover, as already indicated, we believe that a company like Sears ought to be able to own a full service bank. If an institution wishes to specialize, it should have the flexibility to do so, but to impose specialization through a limited charter is unwise.

Another problem with the Sears proposal is that, in the interest of gaining political support, it has been larded with constraints. A "family bank" would be required to restrict its activities to consumer and residential mortgage lending and to limit its remaining investments to liquidity instruments. It would be required by statute to meet significantly higher capital requirements than commercial banks, even though loss experience in consumer lending does not support the need for such a capital ratio. So-called lifeline services would be mandated. Although the proposal contains other features that are in themselves not objectionable, the entire package appears economically sensible only for a large company that already has an extensive brick-and-mortar distribution system and extensive resources. Therefore, I fear the "family bank" could be used by giant companies (like Sears)

with better access to cheaper funds as a way of squeezing out smaller competitors in the long run.

6. In enforcing fiduciary standards would you increase civil money penalties - particularly for mutual savings and loans where no personal capital is at risk? What specific recommendations would you make?

We do not believe greater civil money penalties are needed to improve fiduciary standards. Instead, we believe that federal regulators should have all necessary authority to remove officers and directors and to prevent unaffiliated persons from engaging in improper dealings with an insured institution and that they should then exercise that authority vigorously. Present law does give the agencies authority to remove officers and directors and to enjoin others from participating in an institution's affairs. Two changes may nevertheless be needed: (1) to extend regulatory authority to insulate an institution from undesirable involvement with outsiders and (2) to eliminate the present requirement that a regulator prove dishonesty or willful disregard for sound operation of the institution on the part of an officer or director before he or she can be removed.

The present enforcement powers of regulators of federally insured thrifts and banks are essentially the same. The federal statute governing FSLIC-insured institutions requires that the FSLIC make three showings in order to remove an officer or director or prohibit further participation in the conduct of the affairs of the institution. See 12 U.S.C. § 1730(g)(1). First, in the opinion of the FSLIC, the officer or director must either violate a law, rule, regulation, or a final cease-and-desist order or engage in any unsafe or unsound practice in connection with the institution or breach his or her fiduciary duty. Aiding and abetting a violation is deemed to be a violation as well. See 12 U.S.C. § 1730(r)(3). Second, the FSLIC must determine either that the officer's or director's violation, practice, or breach of fiduciary duty caused the institution to suffer or will cause it to suffer substantial financial loss or other damage or seriously prejudiced the insured member's interests, or that the officer or director received financial gain from the violation, practice, or breach of fiduciary duty. Third, in the FSLIC's opinion, the violation, practice, or breach of fiduciary duty must either involve personal dishonesty or demonstrate a willful or continuing disregard for the safety or soundness of the institution.

An officer or director may also be removed or barred from further participation in the institution's affairs if his or her conduct with respect to another insured institution or other business institution (1) results in substantial financial loss or other damage, (2) evidences personal dishonesty or a willful and continuing disregard for the institution's and soundness, and (3) evidences unfitness to continue as officer or director.

The FSLIC has authority to bar "any other person" from participating in an insured institution's affairs if such person's conduct with respect to that insured institution, another insured institution, or other business institution (1) results in substantial financial loss or other damage, (2) evidences personal dishonesty or a willful and continuing disregard for its safety and soundness, and (3) evidences unfitness to participate in the affairs of the insured institution. See 12 U.S.C. § 1730(g)(2).

Parallel provisions grant the FDIC, the Federal Reserve, and Comptroller removal and enforcement authority against officers, directors and other persons participating in the affairs of FDIC - insured national and state banks. See 12 U.S.C. § 1818(c); 12 C.F.R. §§ 19.26-.29; 263.20-.31; 308.39-.40.

This enforcement authority may be contrasted with that of the National Credit Union Administration (NCUA). Pursuant to Section 206(g) of the Federal Credit Union Act, the NCUA has adopted regulations that permit it to remove, or prohibit from further participation, "any director, officer, committee member, or any other person participating in the conduct of the affairs of an insured credit union." 12 C.F.R. § 747.501 (1985). The NCUA must find that the party: (1) violated any applicable law, rule, regulation, or final cease-and-desist order or engaged in any unsafe or unsound practice in connection with the credit union or engaged in a practice constituting a breach of fiduciary duty as director, officer, or committee member and (2) the credit union has or probably will suffer financial loss or other damage or the insured member's interests were seriously prejudiced by the violation, act, or practice. See id. § 747.502(a).

These regulations further provide that the NCUA may remove a director, officer, or committee member who, by conduct with respect to another insured credit union or other business institution which resulted in substantial financial loss or other damage, evidences personal dishonesty or unfitness to continue in his or her position. See id. § 747.502(b)

Finally, the NCUA may bar "any person participating" in an insured credit union's affairs from further participation if the NCUA finds that the individual's conduct with respect to the insured credit union, another insured credit union, or other business institution resulted in substantial financial loss or other damage and evidences personal dishonesty or unfitness to continue in his or her position.

Although the bank and S&L provisions generally parallel those for credit unions, the latter are notably different and superior in one important respect. The NCUA may remove an individual from participating in a credit union's affairs if he or she is found unfit. Negligent or reckless conduct that threatens safety and soundness may be sufficient grounds for removal. The FDIC, Comptroller and Bank Board, by contrast, must prove not only unfitness, but also personal dishonesty or a willful disregard for the institution's soundness. The latter requirement can be a substantial legal and personal obstacle to effective exercise of these removal powers. During my tenure as Chairman of the NCUA Board, I found that because of the differences in our enforcement powers we had a significant advantage over our sister agencies when we sought to discipline management of an institution.

We would urge that all the banking agencies have the authority to remove officers or directors who have shown that they are unfit to exercise the fiduciary responsibilities they have undertaken. Of course, the agencies' procedures must provide full due process protections to accused individuals.

We believe that there is merit in the proposed legislation submitted by the Bank Board (S. 759/H.R. 1680) to enhance its authority over "institution-related" parties, although it does not go far enough. Title II of that legislation would define such persons to include "any officer, director, employee, agent, or other person participating in the conduct of the affairs of an insured institution, or any service corporation . . . [or subsidiary thereof], or of any savings and loan holding company . . .," and any person who may be required to file a notice under the Change in Savings and Loan Control Act. It goes on to provide that a person's status as an institution-related party would not be affected by resignation, termination of employment, or other separation of such person from the institution.

By expressly extending these enforcement powers to officers, directors and other participants in the affairs of S&L subsidiaries and holding company affiliates, this proposal is a step forward. However, it does not go far enough. First, Title II of S. 769 leaves unchanged the requirement that a showing of personal dishonesty be made. Second, the definition

of "institution-related party" is too narrow. It should include in addition both substantial shareholders and members of their immediate families and those who engage in significant business with the institution or its affiliates. If the actions of any of those persons or entities can be shown to be detrimental to the soundness of the institution, then the regulators should have the authority to bar them from contact with the institution, subject of course to due process requirements. If the Bank Board and FDIC had such authority, for example, each could prevent an institution from engaging in business with a deposit broker when that relationship would be detrimental to the institution. That would be a more effective approach to the legitimate problems arising from brokered deposits than the approach embodied in either the invalidated Bank Board-FDIC rules or Title VIII of S. 2851.

7. In your testimony, you said that regulatory protections from competition will not enhance safety and soundness but will serve to increase risk to the system. If Congress does not change the existing legal system, what will happen? What will be the first signs?

Rigid and narrowly limited powers for thrifts and banks increase, not lessen, risks to the system. Flexibility to organize and conduct business, including to determine what new products to offer and what new lines of business to enter, almost by definition diminishes risk. In addition, depository institutions must have the ability to diversify their activities in order to generate new sources of income and become less subject to the vicissitudes of interest rate cycles. This flexibility is necessary for both individual institutions and the system as a whole. As it evolves, the system must be able to adapt to changes in interest rate patterns, consumer preferences, technology, new competitors and new products. Restrictions make the system rigid, and rigidity causes fragility.

Let us illustrate with two examples.

During the 1970's, the thrift industry concentrated primarily upon taking savings deposits and making home mortgage loans. Regulation Q placed a ceiling on interest on savings accounts and favored thrifts with a 1/4% differential. When the phase-out of Regulation Q was legislated in 1980, it was both necessary and overdue. But it also devastated the thrift industry, which was forced to compete in a vastly different world than had existed a decade earlier. While profound

economic, competitive and technological changes had occurred during the 1970's, the law -- particularly Regulation Q -- both gave thrifts an illusory protection and denied them the legal tools necessary to adapt. Although the difficulties of some thrifts have become more complex in the 1980's, much of the ongoing thrift crisis and the problems of the FSLIC fund are attributable to the rigidities represented by Regulation Q and the timing of its lifting.

My second example concerns the Glass-Steagall Act, a statute that was enacted primarily to separate commercial banking from investment banking and to insulate commercial banks from perceived ill-effects of participating in securities underwriting during the 1920's. In litigation brought by the securities industry, the courts have interpreted Glass-Steagall to restrict severely bank involvement in securities activities. It is now apparent that because of the so-called securitization of loans Glass-Steagall represents a serious restraint on the ability of banks to continue to serve the credit needs of the most creditworthy corporate and consumer borrowers.

Traditionally banks served as the intermediary for translating consumer and other savings funds into loans to corporate and consumer customers. Beginning in the 1970's, technology permitted securities firms to market short-term debt instruments issued by high quality corporations (commercial paper) directly to investors without any bank involvement and at a generally lower cost to the borrower than a corporate loan. The next development was the pooling of mortgage loans and the sale of interests in that pool or instruments backed by that pool (i.e., securities) to investors. By this means, consumer loans can be originated outside a bank or savings association and be funded directly through the securities markets. Although it appears now that banking organizations may be able to participate in the placement of commercial paper, that opportunity was tested in a five-year litigation (that may not yet have concluded), and bank involvement will still be significantly limited and constrained.

The result is that a significant portion of commercial banks' prime business has been taken over by the securities industry, that bank profit margins are being progressively squeezed, and that the marginal risk associated with bank loan portfolios has increased as banks must compete for relatively less creditworthy borrowers. Glass-Steagall largely prevents banking organizations from competing in the securitized loan market. As James McCormick demonstrated in his testimony

before the Committee, this trend is an ominous one for banking, and consequently for the federal deposit insurance funds.

8. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Why?

Yes. Fundamentally, the functions performed by banks, securities firms, and insurers (apart from the pure insurance function represented by term life insurance and casualty insurance) are equivalent. Each is an intermediary for companies and individuals that have funds not needed for current activities and for those who would put those funds to productive use in the economy. In the past, the activities of firms engaged in these respective businesses have been differentiated for reasons of history and technology, and the law in the twentieth century has to a significant extent confirmed that separation, particularly by restraining the combinations of commercial banks with securities or insurance firms. The lines between these industries are primarily a result of the law and tradition, not of underlying market or economic realities.

For example, the courts have indicated that if bank certificates of deposit were not protected by deposit insurance and offered by institutions subject to pervasive banking regulation, they would be "securities" for purposes of the federal securities laws. Likewise, certain insurance products are registered under the securities laws because of their functional similarities to non-insurance investment vehicles.

Another set of examples is the various collective investment vehicles offered by each industry. Banks, securities firms and insurance companies all sponsor collective investment funds in which investors may pool funds that are in turn invested in a diversified array of investments. Insurance companies market these to the public as universal life insurance or variable annuity contracts; and securities firms sell interests in mutual funds. Bank funds are established under trust powers and may be offered only to trust customers. (As a result of litigation brought by the Investment Company Institute under the Glass-Steagall Act, banks have been barred from offering interests in bank-created trust funds to the public, although it may be possible for banks to establish and market collective funds for IRA accounts.)

The development of substitute bank, insurance and securities products increased during the 1970's. Inexorable forces helped to cause blurring of old industry lines wherever

the law would permit it. Technology and telecommunications fostered new products by increasing the number of potential participants in a market, by permitting instantaneous transmission of data and information, and by using computers to make complex products financially feasible and convenient. A notable example is the money market mutual fund, a fund that invests primarily in money market instruments and pays a return at roughly a market rate. It is a securities product that usually may be accessed by check and is therefore equivalent to an interest-bearing checking account. Another example is the cash management account which combines a debit card, money market mutual fund (or bank money market account) for liquid assets, and a securities account into a single service that enhances the customer's ability to shift from one investment to another and to use funds in the account for a variety of other needs. Originally designed by Merrill Lynch, this type of account has been widely imitated by banks and other financial institutions. Products like money market funds and CMA have helped consumers become financially more sophisticated, and they have shown a readiness to accept innovative products from nontraditional suppliers.

Because of increased competition and narrower spreads, insured banks and thrifts, as well as securities brokerage firms and insurers engaged in direct sales through agents, have realized the need to become more efficient by offering more products and generating more revenues out of their existing, and expensive, office networks. All the participants in the financial services market are thus under pressure to provide customers a wide array of products and services and to develop new products to compete with those offered by competitors in other industries.

The forces that have led to the blurring of traditional product lines show no signs of abating. Indeed, their momentum may be increasing. We expect the erosion of these old lines to continue apace.

9. Should Congress authorize joint ventures among and between participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

As answers to previous questions indicate, the law should not restrain the ability of banking and thrift organizations to design products or to enter lines of business according to their assessments of market preferences and their position in the market. Joint ventures represent one means by

which organizations may combine to create new products or services and should be fully available to depository organizations. Only in the case of banking organizations, of course, is Congressional action necessary to permit such joint ventures. No federal law constrains insurance or securities firms from combining.

Congress might consider expansion of joint ventures by bank holding companies as part of a transition to a deregulated system. But Congress should focus on the activities available to depository institutions, not the form of the venture. It would be unwise to limit depository institutions to joint venturing because of the relatively weaker bargaining power of a constrained bank in negotiating with a nonbanking firm that could choose from a wider array of possible relationships. Managers of institutions should be able to choose the best form of relationship.

10. What do you believe the appropriate qualified thrift lender test should be? Why?

A qualified thrift lender ("QTL") test is bad policy and contrary to sound banking principles. A QTL test like the ones contained in S. 2851 and H.R. 20 would impose severe constraints on an institution and would limit its flexibility to adapt its asset portfolio as market conditions change. Rigidity fosters fragility and instability -- in both individual institutions and the system as a whole. A more appropriate test, which would recognize the historical character of all thrift institutions (including savings banks, S&L's, credit unions, and industrial thrifts) and would distinguish them from commercial banks, would limit thrifts to no more than 15% of assets in commercial lending.

We are deeply concerned that a thrift institution under the proposed QTL tests is defined by its mortgage lending activities. This approach is based on politics, not substance. It is bad policy and particularly unfair to savings banks. Historically, the principal purpose of savings banks, quite simply, was to encourage and facilitate savings -- and they have done so successfully. They are therefore true thrifts. Savings banks traditionally have also had power to invest significant amounts in both home mortgage and in consumer loans, which are shorter term credits with greater liquidity and interest rate sensitivity than home mortgages. Consumer loans also spread credit risk among a large number of borrowers.

Savings and loan associations, by contrast, developed as a specialized kind of thrift institution that was particularly appropriate for an era of steady and general economic growth and low, stable interest rates, in which large numbers of middle and working class persons were able to become homeowners for the first time. S&L's thus typically now have asset portfolios that meet the proposed QTL tests.

—But in a far different world like that of the 1980's, it would be a mistake to freeze the development of thrifts by severely limiting their asset portfolios. In the interest of safety and soundness as expressed through liquidity, diversification of credit risk and interest rate sensitivity, thrifts should not be inhibited from greater consumer and other noncommercial lending by the constraints of a QTL test focused primarily on mortgage lending. A less restrictive QTL test, such as one pegged to commercial lending, is thus more consistent with the long-term health and strength of thrifts than those that have been proposed.

If a QTL test of the sort contained in S. 2851, H.R. 20, or H.R. 1680/S. 759 (the Bank Board proposal) is to be adopted, the Bank Board proposal is preferable because of the relatively greater flexibility it would provide.

The CHAIRMAN. Are Mr. Timmerman and Mr. Bentley here? Gentlemen, we are pleased to have you before us today; Mr. Douglas J. Timmerman, president and chief executive officer of Anchor Savings & Loan Association of Madison, WI; and Mr. C.E. Bentley, chairman, United Financial Group of Houston, TX. Mr. Timmerman, would you like to begin?

Senator PROXMIRE. Could I just interrupt by saying how happy I am to see my constituent, Mr. Timmerman, here. I have heard many good things about Mr. Timmerman and, of course, everybody in Madison knows about Anchor Savings & Loan. They have done a superb job. It's very active and growing and a very vigorous operation and one that's respected by the people in the city and the State. It's sort of a model operation. We're happy to have you here.

STATEMENT OF DOUGLAS J. TIMMERMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ANCHOR SAVINGS & LOAN ASSOCIATION, MADISON, WI

Mr. TIMMERMAN. Thank you very much, Senator Proxmire. That's a nice way to be able to begin.

Mr. Chairman, I have previously submitted some comments and I would ask that you accept those into the record. I have additional observations at this time to couple with those comments I made, if that would be appropriate.

The CHAIRMAN. We will be happy to include both of your full statements in the record.

Mr. TIMMERMAN. Thank you.

As Senator Proxmire has indicated, I am the president of Anchor Savings & Loan Association of Madison, WI.

Two points I would like to deal with in a little bit more emphasis from my prepared comments have to do, No. 1, with the dual charter system. The dual system permits an institution such as a savings and loan in Wisconsin to determine whether it will be a Federal or a State-chartered institution.

MAJORITY ARE STATE CHARTERED

The majority of savings and loans in the State of Wisconsin are State chartered. The ratio is about 3 to 1. I'm not sure why this that is so, but the fact remains it is.

We feel the opportunity to have a State option has provided us through the years with additional flexibility, that in turn, we have been able to use to meet the primary objective of home ownership, home finance, and shelter financing. Relating this to the provision of thrift accounts, it's permitted us to meet those goals but also permitted us to meet them with an expectation that we must be profitable and build our net worth. In Anchor's case, and I think in many cases in Wisconsin, this assisted them through the early 1980's when associations found—and in Anchor's case admittedly so—a number of money-losing years. We were able to weather the storm. I guess you might say we had also put money away for a rainy day. It's corny but it worked and we think we owe some of that, maybe a lot of it, to the flexibility of our State charter.

I realize in listening to the testimony of several of my predecessors that there has to be some reason, there has to be some bal-

ance; there has to be some diversity, many times within which a State provides that flexibility.

The State of Wisconsin did not provide us with the opportunity to do everything for everybody, but it did give us what I described in my prepared remarks as modest flexibility. The adjustable rate mortgage existed in Wisconsin in the early 1970's. The ability to—again I'll repeat—modestly—and I can be specific, what is my definition of modest? Well, the legislature defined it— 2.5 percent over the life of a loan. I think that's quite modest by today's standards. It permitted associations to exercise adjustability if it was necessary, and it became necessary in the early 1980's.

So I point to that as one example of what I think a State can do; that its legislature can do for its constituents that is closer to the grassroots, it is closer to home base and meets the needs hopefully with at least equal if not more sensitivity than some of those types of reactions might be produced on a Federal level.

Second, I'd like to refer or reemphasize something else I spent some time on in my prepared testimony.

Anchor Savings & Loan, again as a mutual State-chartered institution, owns and operates a third-party real estate brokerage agency. Federals cannot do this. We can. I was quick to point out in my prepared remarks we also are mandated GAAP reporting. Federals are not.

I am not sure these two illustrations are earth shaking, but I think it does point out we have moved into fields related to housing finance that seem like they are a natural outgrowth, a natural extension, if you will, of housing finance, shelter finance operations, and we have been very satisfied with it.

Certainly, institutions do not have to acquire an equity interest in third-party real estate operations in order to cooperate with them. We simply found in our particular situation, in our particular market, that the opportunity was available to us and we were willing to try it. And again, I emphasize, we believe it has worked very well.

Whether Federal associations should be given this option I think is something that, of course, is one small part of what this committee is struggling with. I certainly would agree with some of the comments I was able to hear related to the fact that the Federal Home Loan Bank System and the Federal Home Loan Bank examination staff need the savings and loans support in doing their job. I think we can cooperate—and I'm always careful to say that—I'm always wondering if somebody is suspicious when they say they get along with the regulators carries with it the inference they're doing things in their best interest ultimately. Though I think words like "fiduciary" and "prudence," have to be assumed, our regulatory system, the Federal Home Loan Bank System, is trying to address those issues.

I believe in the long run it is going to be necessary to open up the opportunities for different financial arenas, different industries to work together. I am not afraid of that. I think we have the opportunity and can very honestly look ahead to opportunities to provide different services from those we have traditionally provided, so I would look favorably on additional competition if it's that. I would look upon it as an opportunity to maybe join with the securi-

ties area or the insurance area in order to provide those things through the institution that I am associated with.

The bottom line I guess, in conclusion, is I think the opportunity to open up the financial arena is a justifiable one and an important one and I would encourage you to continue in what is I'm sure an extremely difficult task of balancing the various lobbies and pressures that you inevitably face.

Thank you very much.

[The complete prepared statement follows:]

* TESTIMONY OF DOUGLAS J. TIMMERMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF ANCHOR SAVINGS AND LOAN ASSOCIATION AT A COMMITTEE HEARING IN ROOM SD-538 OF THE DIRKSEN SENATE OFFICE BUILDING, MAY 22, 1985.

It is always a pleasure to appear before committees and panels such as this one because you clearly have an ability to make a significant impact on the business I am part of -- the savings and loan business -- as well as the whole range and spectrum of financial services. While my testimony will center on six observations about current marketplace events, it is also my intention to give expanded comments about Anchor's acquisition of a third-party real estate brokerage firm. I am hopeful this will assist the committee in examining specific marketplace developments and the formulation of future legislation in response to those trends.

An initial observation has to do with the traditional savings and loan association's focus on shelter and housing. Most of the thrift executives I come in contact with are clearly aware that housing simply is no longer the national priority it once was. Not that the generic concept of housing has gone out of date, nor that the changing national sense is good or bad. The reasons at this juncture of time are not necessarily important either. It is the trend as a reflection of a multitude of market and political interactions that presents us with the market realities of today. As the liability side of the business was deregulated, the asset side had to follow. The result was adjustable rate or interest-rate-sensitive mortgage contracts and instruments that have been marketed more aggressively in the 1980s.

I believe thrift executives are well aware of the fact that the marketplace will present consumers with as many shelter mortgage financing options as can be sold. This is a straight forward -- pure and simple -- extension of democracy's encouragement of the profit motive. No one can or should attempt to legislate only fixed rate contracts nor exclusively adjustable rate contracts as mortgage options to the American home buying public. Conversely, I don't believe Congress should attempt to legislate indexes, caps, ceilings, or other types of mandatory pricing mechanics on those of us who continue to believe mortgage finance is a creditable pursuit and one that can be successful. The State of Wisconsin permitted modest adjustability of mortgage contract rates long before it gained national attention. While it is true this was permissible only for state-chartered associations, the system worked quite well.

This leads me to a second point, centering around the dual charter system for savings and loan associations and savings banks. This, of course, could be expanded to include other financial intermediaries as well. I would encourage you to be especially sensitive to the needs of states and geographic regions in the recognition of chartering benefits that only states and their respective legislatures can provide. The Federal Home Loan Bank Board headed by its able Chairman, Edwin Gray, has encouraged Congress to consider proposals that would conform state-chartered institutions to the same permissible activities of federal associations. The net worth regulations and direct investment regulations seem to already address many of these concerns. Taken to its logical conclusion, there would be no difference in the charter because, in effect, all associations would be federal in the exercise of their permissible lending and investment authorities. This is not true in the commercial banking area, so why is it necessary in the thrift area? However, maybe I should be asking a different question. Is it possible that Congress is not seeking to assess an evolving trend but to start one -- that all financial institutions should be federally chartered?

Let me suggest that there is room for a reasoned middle ground. The Association I am privileged to lead is able to own and operate third-party real estate brokerage activities under our state charter. Federal associations, at present, cannot. However, Wisconsin regulation requires GAAP (Generally Accepted Accounting Principles) in the reporting of financial information, while federals do not.

There are bigger issues here than the examples cited previously. If an association has the authority to invest, under a state charter, in proven riskier investments; then it would seem appropriate that associations be charged higher insurance premiums by the federal depository agencies -- FDIC or FSLIC. Here is an opportunity to reinforce the concept of states rights rather than legislate around it. Given that entrepreneurs will move toward maximum flexibility in the pursuit of profitability, and given that in the pursuit of that goal there will be increased risk taking, then factor the risk premium on a state-by-state experience level. Those states where there has been the greatest exposure and cost to FSLIC should seek to have the remaining qualifying institutions pay twice, three, four, or more times the base premium of states that show small exposure or actuarial experience. Data on deceased financial institutions can probably be traced like deceased humans.

This type of an approach would move control and self-governance closer to the affected groups. State regulators and state legislatures should find their respective constituencies much more cooperative.

A third issue relates to what defines the financial institution's basic character. Financial institutions should pay taxes at levels that are the same regardless of where those revenues and resultant profits come from. Simply put, credit unions, insurance companies, banks, and yes, savings and loans and savings banks should pay the same tax rates in relation to the same income levels. This does not mean, however, that regulation should not try to place broad restrictions on what types of activity and what amounts of investment qualify for appropriate regulatory oversight.

This brings me to a fourth point. The concept of a "thriftiness" test is not all bad; just what activities are involved and where does the revenue come from. If Anchor Savings and Loan wants to do lots of "bank-like" activities, then at some point, it must be classified and come under the jurisdiction of bank regulation. If it wants to be an insurance company or a brokerage firm, then at some point possibly those jurisdictions come into play.

Ultimately, the need for separation and regulation by deposit or loan activity may not be necessary. However, I sincerely believe this reality is some time in the future, if at all.

A fifth area I would like to address is that of regulation or possibly in the case of savings and loan associations -- reregulation. My overall impression is that total deregulation and a blanket coverage through insurance of accounts is contradictory. Another trend or perception is that the public believes all financial intermediaries and financial service providers are federally insured -- they cannot lose. A feeling that the full faith and trust of the United States Government stands somewhere behind the deposits or funds invested with all banks, savings and loans, credit unions, insurance companies, brokerage firms, industrial loan companies, small commercial finance companies, and the like. I say this is what the public does perceive or will argue and expect at the first sign of trouble. Maybe we should require "negative notice" on those documents of non-insured financial service providers akin to the health warnings on cigarette packages or toxic chemical containers. Those institutions that have federal insurance, feature and promote it to the extent many citizens believe it exists for all types of firms and product accounts.

This is just one reason why non-bank banks should be discouraged until adequate guidelines can be developed for their existence. Let's face it -- what is really at stake here is access to customer deposit accounts and customer financial business relationships. If one type of firm or

business is going to accept deposit accounts or transaction accounts, maybe there should be a base-line charge for that access. This might look like a franchise fee or access charge for the privilege of participating in a given business sector -- i.e. financial services. I strongly support legislation closing the non-bank loophole effective July 1, 1983.

The last issue or trend I would like to address is disclosure. I believe any honest business executive is not afraid of having financial information about the business being publicly available. However, it must be consistent. Because insured institutions are regulated, a considerable amount of detailed information is available with the interpretation left to those who seek the information. I would suggest a study should be undertaken that would lead to uniform disclosure of financial information to be released generally by all financial intermediaries that accept depository accounts.

Now I wish to return to one of my comments for elaboration. Wisconsin is one of those 21 states identified as permitting state-chartered mutual associations the ability to acquire real estate brokerage agencies. Anchor did so on October 1, 1983, with the acquisition of a firm known as Coldwell Banker Town and Country Realtors, Inc. Depending on which statistics one uses, this agency was either first or second in brokerage activity in the Dane County marketplace during 1983. It had obtained and continues to retain a franchise license from Coldwell Banker, a nationally known and highly respected successful national franchise network. Coldwell Banker is a wholly owned subsidiary of Sears Roebuck and Company.

Anchor's Directors and management had considered for some time whether the acquisition of a real estate brokerage agency would be in the long-run best interest of the association. With the difficulties of the last several years and the expansion of corporate lending activity provided through the Garn-St. Germain Act, it became apparent that such a move was appropriate. This was further strengthened through numerous Board pronouncements by Chairman Gray and others that the savings and loan industry should continue to build on its shelter foundation and not overlook expansion into new business ventures within its traditional role.

Anchor realized it was stepping into a new arena in the acquisition of an agency. Many people advised us on the pros and cons as they would relate to our relationships with other real estate brokers. May I say that, in general, the other real estate professionals reacted with either fear

or acquiescence. The fear was generated from the fact that this union between Town and Country and Anchor would be operated in a fashion different from an arms-length relationship with an independent broker. I personally had to contend with accusations related to overstated appraisals or favorable transaction terms that simply were not true. Acquiescence was evidenced by many realtors in that they recognized this is the way the business is going. One other realty firm has made a linkage with a national network. Our management believes this is simply the preliminary evidence of what the future holds in our marketplace. Realtors, in general, are looking for funding reliability for the long term and cannot tolerate the situation that evolved during the early 1980s. Together they must work with the savings and loans if both are expected to maintain their vital role in financing American shelter.

In conclusion then, let me make the following observation. Anchor's acquisition of a real estate brokerage agency seemed like a natural outgrowth of the kind of activity it had been involved in for over 60 years. We believe that such a relationship enhances the Association's long-run vitality and financial health. All those criticisms about such an arrangement can be dealt with if adequate disclosure is made to prospective customers about the affiliation. Anchor makes such information readily and easily known to all parties involved in a potential real estate transaction where our wholly owned agency subsidiary is involved. Maybe my greatest surprise was the fact that we had not taken this step sooner. While some may feel there are disadvantages, I believe firmly that there are many more advantages for the long term.

* Douglas J. Timmerman, Ph.D., is President and Chief Executive Officer of Anchor Savings and Loan Association, Madison, Wisconsin. Anchor is a 67-year old, state-chartered, federally-insured, mutual thrift institution operating 28 offices primarily throughout south central and southwest Wisconsin. At April 30, 1985 assets stood at \$1,017,803,000; the most recent fiscal year ended March 31, 1985 yielded an audited profit of \$6,537,000; and a present GAAP net worth of 3.51%. Anchor Savings is a member of the U. S. League and Wisconsin League of Financial Institutions.

The CHAIRMAN. Well, I certainly will continue. You're certainly an example. Some of the activities you're involved in we haven't even dared propose for nationals, and yet you're sound and secure and doing a good job. And as I listen to some of the horror stories about what can be done if we grant more powers, certainly you show that is not necessarily true.

Mr. Bentley, I must apologize to you. I have got to leave for a commitment that started 11 minutes ago, but Senator Proxmire is going to stay. He certainly has plenty of experience to take over the committee for the remainder of the day, having served as chairman. I do apologize to you for having to leave but Senator Proxmire will stay and hear your testimony and ask questions.

Senator PROXMIRE. Thank you, Mr. Chairman.

Go right ahead, Mr. Bentley.

STATEMENT OF C.E. BENTLEY, UNITED GROUP FINANCIAL, INC.

Mr. BENTLEY. Thank you, Mr. Chairman.

I am C.E. Bentley, chairman of the board of United Group Financial, Inc., a savings and loan holding company. I am also senior chairman of United Savings Association of Texas, a Houston-based, State-chartered, federally insured stock savings and loan institution with 65 branches in the State of Texas. By way of personal background, I have been in the savings and loan business and with the same company for 42 years. In that time I had the pleasure of serving as president of the Texas Savings & Loan League and, more importantly, on the Finance Commission of Texas for 12 years during which time the regulations under which State-chartered savings and loans operate were promulgated. I appreciate very much your kind invitation to come here and share some of this experience with you.

I am somewhat familiar with the testimony received by this committee in recent weeks concerning the health of the thrift industry, the FSLIC and recommendations for improving both. I am sure that the issues raised in this area are of great concern to each member of the committee and rightly so. Before commenting on specific issues, I want to assure the committee that I take very seriously my responsibilities as the manager of a federally insured, State-chartered savings institution. I am, at the same time, here to defend, unapologetically, the State-chartered system. If I do nothing else here today, I hope I can convince you that these two principles are not inconsistent.

Much has been made here and in the news media about the weakened condition of thrifts, the shallow capital, threats to the FSLIC and so on. Given the fact that Garn-St Germain is only 2½ years old and that some State powers have recently been enacted, it is all too easy for anyone to jump to the conclusion that deregulation or new powers have been the root cause of the problems. Nothing could be more incorrect. Financial institution failures which have occurred in recent months would, in all likelihood, have happened in any case. They are the product of mismanagement, poor judgment, fraud, and inadequate regulatory oversight, in varying degrees and mixes.

TESTING GROUNDS FOR NEW PRODUCTS

The tension between State and Federal authority to empower and regulate depository institutions is nothing new. It is inherent in the dual system. For most of the history of that system the tension has been a creative one for both banks and thrifts. More often than not, State depository systems have proven to be valuable laboratories or testing grounds for new products and services which, if successful, spread to other regions and are eventually adopted by the Federal system. As serious as the FSLIC condition is, it does not justify sacrificing this testing ground which I submit is what has been proposed in varying degrees—most recently in the legislative submission of the FHLBB of May 3. If Congress were to grant to a Federal regulator, in effect, a veto power over State law, then the dual system ceases to exist for any meaningful purpose. There would be no reason to exist as a State-chartered entity. And in reflecting here in Washington, I wonder where our great Government would be today if for 200 years we had been under a one-party system.

This proposal is the most extreme but not the only case of anti-State prejudice which is creeping into the discussion of the thrift industry. Chairman Gray's earlier bill, S. 759, proposes a Federal-State variable on FSLIC premiums. Under that plan, any State savings and loan using investment authority different than a Federal association would pay a higher premium. It has also been suggested that the level of deposit insurance be lowered for these State associations.

All of these ideas have one common thread—the idea that any power bestowed on Federal thrifts by the Congress is deemed safe, any power conveyed by a State legislature is automatically determined to be unsafe or high risk. Put another way, if it originated in Washington it is OK; if it originated in a State capital it is not OK. That is the message many of us are hearing from the discussion that has gone on to date.

Let me clarify this point. I am not rejecting the concept of risk-based insurance premiums. I am rejecting the notion that the sole criteria of risk should be State powers as is the case in S. 759.

The second general point I want to make is that no investment lending power is safe or riskless in the hands of incompetent or dishonest people. What is competent management? In our business it is the ability to manage risk. That involves knowledge of markets, financial instruments, and a host of economic variables.

The failures in the thrift industry of the last 2 years have not been the result of risky investments. They have resulted from bad investments by incompetent and, in some cases, dishonest people. Adopting laws or regulations limiting certain types of investments ignores this single, profound truth.

For every savings and loan failure attributed to real estate investments, there are dozens of savings and loans that are profitable and getting stronger because of sound real estate investments.

The only way to get at the quality of management issue is by better examination and supervision. The Federal Home Loan Bank Board took a good first step in this regard by moving the examina-

tion staff to the district Federal Home Loan banks. This move should enable the system to attract and hold better examiners.

Quite frankly, Mr. Chairman, deregulation came a lot faster than our regulatory structure was able to accommodate. This friend of mine, a supervisor in the State of Texas, said that a lot of problems today come from the fact that when the regulation came there were very few managers and no supervisors prepared to cope with the change.

EXAMINERS FLOODED WITH SWIFT CHANGES

I am not blaming anyone. It is just a fact that examiners just can't keep up with the fast paced changes and innovations which the market dictated on the thrift industry. Unfortunately, a lot of unscrupulous people are taking advantage of the situation. Only case-by-case hands-on law enforcement supervision can deal with this situation. What is needed is not powers regulation but better examination and prosecution of crooks.

There is one type of investment regulation that I do favor. Institutions which do not meet minimum net worth standards should be more closely supervised in their investment strategy. The reason for that is quite simple. When I make an investment decision it is the net worth of United Savings at risk first, not the FSLIC. If an association has inadequate net worth, then the risk to FSLIC would be more direct.

Let me make a point here as to direct investments. In excess of 50 percent of United Savings' current net worth of approximately \$180 million was contributed by profits on our direct investments. These earnings, however, were created at the time by less than 3 percent of our total assets. We have now expanded beyond that 3 percent in order to keep building net worth. We are certainly not abandoning the home mortgage market, not at all. The facts are, however, that with deregulation and greater competition in the mortgage market the spreads on mortgage loans are getting smaller and smaller. We have to diversify somewhat to areas of higher profit margins in order to compensate for this trend. Quite frankly, the best contribution I can make to the health of the FSLIC is to run United Savings at a profit. Profits build real net worth, and building real net worth in savings and loans is the only true and lasting way to strengthen the insurance fund. New regulations and laws which constrain our profit potential will only serve to keep the FSLIC and the industry dependent upon Government assistance and accounting gimmicks.

One last personal comment, if I may, Mr. Chairman, make. I know that hearings were held on the Hill in connection with the Empire-Mesquite incident and I read the results of the large group of press related to that, and there is one issue that I am not sure has been made clear. If I may, I'd like to take about 2 minutes to try to clear it.

One, a lot of allegations were made about Mesquite's saying that it was those broad Texas powers that let that take place. There was really only one way that Texas powers let that happen, and that is the fact that we have the right for State-chartered institutions to

invest under Federal regulations and it was under Federal law that those bad loans on those condos were made.

The Texas law provides that you make a loan of x percent of value, cost or sales price, whichever is lesser. The Federal law under which those loans were made simply says that you can make x percent loan of value.

Now you compound that or you let that situation exist with a frivolous appraiser and crooks on both ends of the transaction, and you've got dynamite. But I simply wanted to inject that it was not broad powers that permitted that to happen.

I appreciate very much the opportunity to be here.

[The complete prepared statement follows:]

Testimony of
Mr. C. E. Bentley
of
United Group Financial Inc.

Mr. Chairman, Members of the Committee, I am C. E. Bentley, Chairman of the Board of United Group Financial Inc., a savings and loan holding company. I am also Senior Chairman of United Savings Association of Texas, a Houston-based state chartered, federally insured stock savings and loan institution with 65 branches in the state of Texas. By way of personal background, I have been in the savings and loan business for 42 years. In that time I served as President of the Texas Savings and Loan League and also served for 12 years on the Finance Commission which promulgated the current state regulations for state chartered savings associations. I appreciate very much your kind invitation to me to come here and share some of that experience with you.

I am somewhat familiar with the testimony received by this Committee in recent weeks concerning the health of the thrift industry, the FSLIC and recommendations for improving both. I am sure that the issues raised in this area are of great concern to each member of the Committee and rightly so. Before commenting on specific issues, I want to assure the Committee that I take very seriously my responsibilities as the manager of a federally insured, state chartered savings institution. I am, at the same time, here to defend, unapologetically, the state chartered system. If I do nothing else here today, I hope I can convince you that these two principles are not inconsistent.

Much has been made here and in the news media about the weakened condition of thrifts, the shallow capital, threats to the FSLIC and so on. Given the fact that Garn-St Germain is only 2 1/2 years old and that some state powers have been recently enacted, it is all too easy for anyone to jump to the conclusion that "deregulation" or "new powers" have been the root cause

of the problems. Nothing could be more incorrect. Financial institution failures which have occurred in recent months would, in all likelihood, have happened in any case. They are the product of mismanagement, poor judgment, fraud, and inadequate regulatory oversight, in varying degrees and mixes.

State Powers vs. Federal Powers

The tension between state and federal authority to empower and regulate depository institutions is nothing new. It is inherent in the dual system. For most of the history of that system the tension has been a creative one for both banks and thrifts. More often than not, state depository systems have proven to be valuable laboratories or testing grounds for new products and services which, if successful, spread to other regions and are eventually adopted by the federal system. As serious as the FSLIC condition is, it does not justify sacrificing this testing ground which I submit is what has been proposed in varying degrees - most recently in the legislative submission of the FHLBB of May 3. If Congress were to grant to a federal regulator, in effect, a veto power over state law then the dual system ceases to exist for any meaningful purpose. There would be no reason to exist as a state chartered entity.

This proposal is the most extreme but not the only case of anti-state prejudice which is creeping into the discussion of the thrift industry. Chairman Gray's earlier bill (S.759) proposes a federal/state variable on FSLIC premiums. Under that plan, any state savings and loan using investment authority different than a federal association would pay a higher premium. It has also been suggested that the level of deposit insurance be lowered for these state associations.

All of these ideas have one common thread - the idea that any power bestowed on Federal thrifts by the Congress is deemed safe - any power conveyed by a state legislature is automatically determined to be unsafe or

high risk. Put another way, if it originated in Washington it is okay - if it originated in a state capital it is not okay. That is the message many of us are hearing from the discussion that has gone on to date.

Let me clarify this point. I am not rejecting the concept of risk based premiums - I am rejecting the notion that the sole criteria of risk should be state powers as is the case in S. 759.

Quality of Management

The second general point I want to make is that no investment lending power is safe or riskless in the hands of incompetent or dishonest people. What is competent management? In our business it is the ability to manage risk. That involves knowledge of markets, financial instruments, and a host of economic variables.

The failures in the thrift industry of the last two years have not been the result of risky investments - they have resulted from bad investments by incompetent and some cases, dishonest people. Adopting laws or regulations limiting certain types of investments ignores this single, profound truth.

For every savings and loan failure attributed to real estate investments, there are dozens of S/Ls that are profitable and getting stronger because of sound real estate investments.

The only way to get at the quality of management issue is by better examination and supervision. The FHLBB took a good first step in this regard by moving the examination staff to the district Home Loan Banks. This move should enable the system to attract and hold better examiners.

Quite frankly Mr. Chairman, deregulation came alot faster than our regulatory structure was able to accommodate. I am not blaming anyone it is just a fact that examiners could not keep up with the fast paced changes and innovations which the market dictated on the thrift industry. Unfortunately, alot of unscrupulous people have been taking advantage of this situation.

Only case-by-case hands on "law enforcement" supervision can deal with this situation. What is needed is not powers regulation but better examination and prosecution of crooks.

Regulation of Investment Decisions

There is one type of investment regulation that I do favor. Institutions which do not meet minimum net worth standards should be more closely supervised in their investment strategy. The reason for that is quite simple. When I make an investment decision it is the net worth of United Savings at risk first - not the FSLIC. If an association has inadequate net worth then the risk to FSLIC would be more direct.

Let me make a point here as to direct investments. 50% of United Savings current net worth of approximately \$180 million was contributed by profits on our direct investments. These earnings, however, were created by only 3% of our total assets. We have now expanded beyond that 3% in order to keep building our net worth. We are not abandoning the home mortgage market - not at all. The facts are, however, that with deregulation and greater competition in the mortgage market the spreads on mortgage loans are getting smaller and smaller. We have to diversify somewhat to areas of higher profit margins in order to compensate for this trend. Quite frankly, the best contribution I can make to the health of the FSLIC is to run United Savings at a profit. Profits build real net worth, and building real net worth in S/Ls is the only true and lasting way to strengthen the insurance fund. New regulations and laws which constrain our profit potential will only serve to keep the FSLIC and the industry dependent on government assistance and accounting gimmicks.

Senator PROXMIRE. Thank you, Mr. Bentley.

Mr. Bentley, let me start with you. I understand your views on States rights and the dual banking system and I agree wholeheartedly. But we have a problem here.

How should we protect against States granting inappropriate new authorities when all the risk is with the Federal insurer, the FSLIC, and the Federal Government?

Mr. BENTLEY. I can speak only, Mr. Chairman, from my experience in Texas. Our rules and regulations have been in effect there since the early 1960's and we saw no abuse coming from any of those wider and larger powers. Ironically, there were very few people who exercised them—consumer lending and a few other areas, direct real estate investment and creation of subsidiaries were largely the areas which caused no real risk to the FSLIC at all.

Senator PROXMIRE. Didn't you have a recent spectacular failure in Texas? You mentioned something about it.

Mr. BENTLEY. I mentioned the *Empire* case. That's the only failure that I'm familiar with.

Senator PROXMIRE. Well, whether it's Texas, or Maryland, or wherever it occurs, if the Federal Government is providing the insurance, we could make a case that the Federal Government ought to have a say in the regulations.

Mr. BENTLEY. I'm glad you mentioned the Maryland situation. It's unfortunately a fact that in Maryland and Ohio all the institutions were State chartered. They were not federally insured. I am here speaking on behalf of State-chartered, federally insured institutions.

REMEDY IS FEDERAL INSURANCE

Senator PROXMIRE. That's right, but of course one of the remedies proposed, the prime remedy I presume, is that in the future they will be federally insured.

Mr. BENTLEY. That's correct.

Senator PROXMIRE. My point is that if in the future they are federally insured, then the Federal Government ought to have the opportunity to prevent them from getting into areas that involve excessive risk.

Mr. BENTLEY. Yes, I think that's true. It may be that we're discussing the matter of what is excessive risk. I suppose my testimony here today says that better than 50 percent of our net worth has been built in dealing with the powers which created no risk for the FSLIC.

Senator PROXMIRE. What's wrong with the Bank Board's proposal, if that is true?

Mr. BENTLEY. For an institution of our size, I frankly see very little wrong with it. I think it does probably prevent some smaller institutions from playing catchup a little faster.

Senator PROXMIRE. Mr. Timmerman, do you see any problem with the Bank Board's proposal?

Mr. TIMMERMAN. Really not, Senator. I think my main concern, as I understand the proposal at this juncture, is how will the jurisdiction be handled; what does it mean when there is a difference

between what a State might permit and what a Federal, say in this case the FSLIC, would sanction? How does that translate into a risk factor, a risk premium?

I guess that would be the primary focus of my concern at this point.

Senator PROXMIRE. What criteria should be used by regulators in assessing whether a particular institution should be permitted to engage in a new activity?

Mr. TIMMERMAN. Well, I suppose one might be the existence of that activity within the marketplace. In other words, if there is some substantive research that can be gathered that would indicate what the experience of other providers of a particular service or what the investment results of a particular product have been. Granted, many of the products that come along are new, but they have their roots in ones that have been evolving for some time.

So I would suggest to you one way to respond to that would be to try to assess what the success of others has been in those arenas, if possible.

Senator PROXMIRE. You see, there's such a difference between Wisconsin on the one hand and some of the other States like California on the other.

For instance, I would be concerned about the problem of an institution getting into direct equity investments compared to lending with collateral to a firm or an individual.

Mr. TIMMERMAN. Well, yes, I admit I have a bias with what I know best, and that is what the State has done in Wisconsin. I suggested—and I grant you somewhat experimentally in my commentary that if there are broad powers within a given State's boundaries and if there can be some actuarial track record established over time, then quite possibly those institutions should bear the responsibility for permitting those kinds of excesses to take place if, in fact, they placed the insurance fund at risk.

Senator PROXMIRE. Well, for instance, if you were sitting in Chairman Gray's position, he's seeking to address a situation where a few States seem to have gone hog wild in allowing unlimited new powers to the thrifts. The FSLIC and ultimately the entire S&L industry will have to pick up the pieces if that happens.

So why should prudently managed savings and loans in Wisconsin be required to pay for the excesses of the high flyers in California or Texas?

Mr. TIMMERMAN. I can't disagree with that. I don't think they should be.

Senator PROXMIRE. Do you disagree with that, Mr. Bentley?

Mr. BENTLEY. No. I feel, however, that what is needed is better, quicker and more efficient supervision and examination.

Senator PROXMIRE. Mr. Timmerman, why do you believe that affiliation with a realtor enhances the association's long-run viability? What are the advantages? What factors made you make the decision to go with Coldwell Banker? Do you think Federal S&L's should be given the same authority and why?

Mr. TIMMERMAN. First of all, I think you need to understand that we believe our future, at least in the near term—and I'm not sure there's any such thing as long-range planning any more—but in the near term anyways, is still tied to home finance and shelter

financing. Our portfolio as it exists speaks to this and what we have been doing in the last several years continues to reinforce that.

So to take that objective or take that belief on our part, our management's and directors' part, I think we then looked within the shelter arena and asked the question: How are we going to continue to be related and associated and linked to individuals and institutions that provide that kind of product for us?

And so I would say, quite broadly, we believe the realtor network gives us at least one of those answers.

Senator PROXMIRE. Well, now apropos of that, Anchor's acquisition of Coldwell Banker's Town & Country Realtors does provoke the obvious question of conflict of interest.

What mechanisms have you developed to prevent conflicts of interest between your brokerage activity and lending and mortgage activities which otherwise might seem to imply problems of safety and soundness?

Mr. TIMMERMAN. I suppose the greatest one, the biggest one, is disclosure.

Senator PROXMIRE. Disclosure?

FULL DISCLOSURE TO INVESTORS

Mr. TIMMERMAN. The fact that our customer knows they are dealing with a wholly owned subsidiary, they know that there is a likelihood and, in fact if it occurs in actuality that Anchor Savings & Loan is providing the funds for this. Also, to some extent, Senator, we internally—and again, at our directors' mandate—we have separated the underwriting function from the more traditional mortgage banking or loan production function.

So I would answer with those two general type responses. No. 1, disclosure to the public; and No. 2, in having an internally balanced system that has some integrity as far as the underwriting process.

Senator PROXMIRE. Of course, that might vary from institution to institution, the latter part of it. The disclosure is really to let the investor beware, but give him information and if he doesn't pay any attention to the information that's his problem.

Finally, I'd like to ask you the same question I asked Mr. Connell. Should the Congress mandate thrift institutions to achieve capital adequacy according to generally accepted accounting standards by a date certain or otherwise be merged out of existence?

Mr. TIMMERMAN. I guess I have to come at that in two ways. No. 1, I think there has to be a consistent definition here, and because we function under generally accepted accounting principles, I confess to you it's easy for me then to say that we need a format that is at least uniformly accepted.

So from that standpoint, from the accounting treatment, I don't have any problem.

Senator PROXMIRE. Well, also from the disclosure standpoint. If you're going to have disclosure that means anything, you have to have a standard that everybody understands. That's why we passed the Truth-in-Lending Act, to provide that the measure or the standard for interest be the same everywhere so you couldn't be

fooled by people saying they were giving you 6 percent interest when it was really 12 or 18 percent.

Mr. TIMMERMAN. The other part of your question, though—I think I would say, generally, yes. I think we have to accept the fact that the arena in which we participate, the financial services and ultimately the public arena, needs to be assured there is capital integrity, if I could use that expression, with the institutions that they do business with.

I would tend, however, to agree with one of the previous presenters that the Net Worth Certificate Program probably should be continued but I don't think it's unrealistic that a 5-, or 7-, or even a 10-year timeframe is undoable.

Then I have to come back to the question: What is capital adequacy? But that's another issue.

Senator PROXMIRE. Well, thank you, gentlemen, very much.

The committee will stand in recess until June 4 when we will hear from the Secretary of the Treasury, James Baker.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Response to written questions of Chairman Garn from Douglas J. Timmerman, C.E. Bentley and additional material for the record follow:]



ANCHOR

Savings & Loan Association

August 15, 1985

Senator Jake Garn
United States Senate
Committee on Banking, Housing and Urban Affairs
Washington, D. C. 20510

Dear Senator Garn:

It is my desire to submit the following comments in response to your questions that were provided to me by Jim Boland.

1. Why do you believe that affiliation with a realtor enhances the Association's long-run viability? What are the advantages? What factors led you to make your decision? Do you think federal savings and loans should be given the same authority? Why?

In order to answer the first part of the question, one must begin with the assumption that the savings and loan has a long-run desire and interest to remain closely allied with the shelter industry. Affiliation with a strong realtor network enhances the Association's ability to attract mortgage loans, both for sale into the secondary market and for retention into the Association's own portfolio. Anchor's management looked at the matter of realtor affiliation in terms of outright ownership, some type of joint venture or joint equity partnership, and also from the standpoint of some type of loose-knit realtor network. All of these approaches had their advantages and disadvantages, but Anchor concluded that because of its size and market dominance in southwest and south central Wisconsin, an outright ownership affiliation with a major local entity linked to a known national network would be our best move. As to whether federal savings and loans should be given this same authority, it is difficult for me to answer that because I am not convinced that ownership of a realtor network is the only alternative available in order to establish more concrete linkage between a savings and loan association and a given realtor or realty network. I frankly believe that federal savings and loans do have the opportunity today under present regulation to enter into numerous arrangements wherein they can be a major partner with local realtors in an effort to provide key services in return for the placement of business. Frankly, I believe local regulation is better able to deal with the supervision of association-real estate brokerage affiliations than can be accomplished at the federal level.

Here, also, is an opportunity to affirm the dual system of financial institution regulation and state's rights philosophy. I don't believe this is an issue that deserves attention at this time.

2. In your testimony you mentioned Anchor's acquisition of Coldwell Banker Town & Country Realtors and the concerns in the real estate industry about conflicts of interest. What mechanisms has Anchor developed to prevent conflicts of interest between its brokerage activities and its lending or mortgage activities?

First and foremost is the understanding that the real estate company is an independent company. It has its own management and Board of Directors and the realtors who are employed by Anchor Real Estate Services are independent contractors in the legal sense. No underwriting is done by the real estate firm. Underwriting is reserved for the Association and ensures an arms length review of all real estate proposals being brought to it by the realty company.

Secondly is the position taken by the Wisconsin Commissioner of Savings and Loan wherein he has insisted that there be adequate disclosure of the affiliation of a realtor with a savings and loan both in public advertising that is done and to each customer contact at the initial point of potential business.

The last reason may be the most important. All lending programs available to Anchor's wholly owned subsidiary, Anchor Real Estate Services, are the same programs in every respect as are being offered to all other realtors and the general public. Our experience in this arena leads us to believe that if there is to be a concern expressed by the real estate industry about conflict of interest, it is going to be in an area where those real estate interests see preferential treatment being given to a captive subsidiary. That is not the case in our situation and would be a basic tenet in the operation of a real estate association relationship through time.

3. In your opinion, it will be necessary in the long run to open up the financial arena so that financial companies can provide new products and services. Why? When will such authorization be necessary? What are the risks if our legal system does not recognize these trends?

It is very difficult for the legislative process to lead, in a very meaningful way, the evolution of financial services; but more importantly, that legislative process should be responsive to evolutionary changes as they take place so as not to encumber or impede the broad availability of new products and services to all financial service providers. Intertwined in this whole process of deciding what and when new services should be made available more generally is a question relating to the insurance of accounts. It would appear from some studies and commentaries provided, that greater numbers of varied services lead to greater risk of financial failure and in turn greater pressure on the traditional federal depository insurance

funds to make up that shortfall. I believe that in order to ensure that management takes on new authorities in a competent and well-thought-out manner, authorization for new services should somewhat lag the general marketplace. For example, if the brokerage community wishes to offer a money market mutual fund, and the citizens wish to put their funds in such an uninsured instrument, that is no reason why there should be quick and immediate institution of that authorization for insured institutions.

4. In your opinion, what would be an appropriate qualified thrift lender test and why.

It is difficult to understand completely why a qualified thrift lender test is necessary if present authorization and regulation do not permit associations to wander too far afield from their original charter. For example, if a state chartered institution in Texas has authority to invest up to 100% of its assets in non-shelter activity, that charter by definition should not entitle that savings and loan to a thrift status, but would be better placed in the commercial banking arena. Section 4 of HR 20 includes an amendment to the Savings and Loan Holding Company Act and institutes a thrift lender test. The qualified institution is required to hold 65% of the institution's assets in residential mortgages and related investments. Mortgage banking activities and that of mortgage banking subsidiaries should count for 10% of that 65% total. In addition, full credit for all liquidity should be included in the 65% test. The fact that the charter is state or federal is not the important factor, but what that charter permits the association to do. If the major focus of the authorization is to encourage shelter and home ownership, then that association should be permitted the benefits of home loan bank membership. Consequently, I tend to endorse the U. S. League position, which respects the fact that the association's main investment will be real estate and traditional shelter. There is generous provision within the U. S. League's position to count a number of elements toward a qualified thrift lender status.

Sincerely,



D. J. Zimmerman
President and
Chief Executive Officer

DJT/s

RESPONSE TO QUESTIONS POSED WITH REGARD TO TESTIMONY OF MAY 22, 1985 FROM
C. E. BENTLEY



United Savings OF
TEXAS

10333 Harwin, Houston, Texas 77036

1. Reactions to testimony of Mr. Connell

Generally I agree with Mr. Connell on fiduciary standards for Trustees or Directors; however, the "conflict of interest" law and regulations seriously affect attracting knowledgeable and competent directors. This restriction should be revisited by Congress.

I heartily agree on tough enforcement, supervision and examination. Mr. Connell makes a strong case for broader investment powers with his statistics on New England savings banks. I somewhat disagree with regard to limitations on certain types of investments. An overall limitation on direct investments (such as the Board has implemented) makes good sense so long as the regulations continue to provide for exceptions in justifiable cases. Also institutions with higher than minimum net worth (5 or 6%) should be exempt from these restrictions or should automatically qualify for higher investment levels.

I also differ with Mr. Connell on so called "junk bonds." I believe prudent investment in "junk bonds" can be made given a separate loss reserve (1/2 to 3/4%) and proper diversification of the bond portfolios.

2. Thrift test

If the purpose of such a test is to determine what, if any, thrifts are sufficiently bank-like that they should be regulated like banks then I suggest that a "bankness" test be used. The standard should be a commercial loan standard exceeding some minimum amount; that is, the level permitted to Federal S/Ls.

**AMERICAN
LAND TITLE
ASSOCIATION**

1828 L Street, NW
Washington, DC 20036
202/296-3671

May 29, 1985

The Honorable Jake Garn
Chairman
Banking, Housing and Urban Affairs Committee
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Garn:

The American Land Title Association (ALTA) appreciates the opportunity to express its views on the financial services deregulation issue. ALTA is the national trade association of the land title industry, and represents in excess of 150,000 individuals employed as title insurance underwriters, title insurance agents and land title abstracters.

The land title industry is vitally concerned with problems affecting our nation's financial institutions. Last year, in testifying before the Committee, ALTA recommended a brightline distinction between banking and commerce activities for the sake of the continued safety and soundness of the banking system. In the wake of the crisis of confidence in Ohio and Maryland, ALTA reiterates its opposition to legislation that would enable a bank holding company through its subsidiary to engage in new activities that would compound the supervisory challenges already facing banking regulators. We support legislation, such as last year's S.2851, that would prohibit the blending of insurance and banking activities.

In addition to the reasons expressed by the insurance industry for continued separation of banking and insurance, this statement will address certain unique risks and problems that would be created if banks, their holding companies or even a savings and loan service corporation were permitted to provide affiliated title insurance on their own mortgage loans. ALTA believes such arrangements would be anti-competitive and anti-consumer.

Anti-Competitive Implications

By way of background, title insurance is somewhat unique in that it is only purchased in connection with a real estate transaction. Because the volume of real estate transactions is dependent on the availability of mortgage money and on the continued health of financial institutions, problems that jeopardize the safety and soundness of these institutions will inevitably jeopardize the land title industry. In light of the billions of dollars in mortgage loans held by lending institutions, there can be little question that lenders as well as consumers have a vital stake in the continued health of the land title industry.

The competitive problems posed by the entry of lender-affiliated companies derives from the ability of each lender to channel the title insurance business arising out of its own mortgage lending transactions to its own captive title company. The Committee must consider the consequences stemming from the fact that lenders who enter the title insurance business will be in a position to issue title insurance policies on their own loans.

On the competitive issue, there cannot be any reasonable differences of views. A title company owned by a financial institution, or a subsidiary of a financial institution, has an insuperable advantage in obtaining the financial institution's title insurance business. Independent, unaffiliated title companies cannot realistically expect to overcome such a "controlled business" arrangement. This market foreclosure problem is particularly severe in the case of title insurance because there is no renewal market. A title insurance policy is issued for a one time premium paid at the time the mortgage loan is paid. Even if anti-tying prohibitions are adopted, it is virtually certain that a significant portion of the lender's title insurance business would still be handled by its captive company. While independent title companies can attempt to compete, it is unrealistic to expect the bank or savings and loan to recommend the services of an independent title company provider when its holding company or service corporation has a significant investment in a title company whose profitability is contingent on a high volume of transactions.

Thus, the ultimate competitive effort of the expansion of bank holding companies and/or savings and loan service corporations into the title insurance business will be:

- . . . market foreclosure
- . . . the elimination of a significant number of independent title companies
- . . . decreased competition
- . . . the demise of impartial title insurance expertise

Anti-Consumer Implications

In determining the public policy implications of expanding the powers of financial holding companies and service corporations, the Committee must take into account the potential impact on consumers. ALTA is convinced that there are serious risks created for borrowers by mortgage lender ownership of title insurance underwriters and the title insurance agencies.

Most consumers do not have the time or incentive to make an informed selection of a title company on their own. Consumers rely on the recommendation of the mortgage lender or other real estate professionals. When the mortgage lender is affiliated with a title company, it is inescapable that the lender's recommendation will be made in order to increase the business of the title insurance subsidiary - not necessarily in the best interests of the consumer.

Another consumer problem created by lender ownership of title companies derives from the fact that the borrower's interest in the property and the protection he needs from a title insurance policy is not coincident with the lender's interest. While a controlled title company will be certain that the lender's interest is protected, the same certainty does not necessarily exist with regard to the protection that the borrower may need.

While the mortgage lender may be unconcerned about potential claims (easements, survey problems) these claims or problems may be of concern to the borrower, who is interested in the peaceful use of the property. Thus, there is a serious question regarding the extent to which a controlled title company will feel constrained to provide the scope of protection to consumers now offered by independent title companies that must compete for the consumer's business. This is particularly the case when the lender owns the title insurance underwriter, since providing such protection to the consumer may result in greater costs or losses to the insurer - and hence reduced profits to be returned to the financial institution/holding company/service corporation owner.

Of particular note, lender ownership of title companies may adversely affect consumers in that such arrangements will generate an upward pressure on rates. With "guaranteed" title business (lenders steering consumers to use controlled title company), the lender-owner is in the "cat bird's seat" to cause title insurance underwriters to increase the portion of the premium retained by the captive title company.

Inevitably, the increased costs in compensating captive agencies for their control over a significant volume of title insurance business will be borne by consumers through higher title insurance rates. In this regard, the title insurance market could become similar to that which exists with regard to

credit life insurance, an area where serious overcharges have been well documented at Committee hearings.

Thus, the ultimate effect on the consumer of the expansion of bank holding companies and/or savings and loan service corporations into the title insurance business will be:

- . . .steering of business by mortgage lender owner to captive title company
- . . .conflict of interests in quality and scope of title insurance protection offered by captive company
- . . .controlled title insurance business will generate higher prices to the consumer

Conclusion

Last September, the Senate approved S.2851, a bill that would have restricted banks from engaging in the business of insurance. The House failed to consider S.2851.

Whatever new version of S.2851 is being contemplated by the Committee, ALTA strongly supports the continuation of the existing restrictions on insurance activities of bank holding companies that are contained in section 4(c)(8) of the Bank Holding Company Act. In addition, ALTA supports statutory language that would close the so-called "South Dakota loophole" thus making it crystal clear to one and all that Congress has made a policy determination - namely banks and insurance "do not mix."

In light of the conflicting ways that federal banking regulatory agencies have dealt with the financial services deregulation issue, ALTA urges the Committee to process legislation similar to that contained in the Bank Holding Company Act to make such restrictions applicable to all other federally regulated financial institutions, including savings and loan holding companies, services corporations and FSLIC insured state chartered institutions.

Now is the time for Congress to shore up the public's confidence. Banks don't run on money - they run on confidence.

Legislation must be adopted - soon - that provides financial institutions and consumers alike with a list of do's and don't's to clarify the functions of banks and financial service providers in the marketplace. The events of the last couple of years - the post-financial services deregulation period - have brought ALTA to the conclusion that until the full implications of steps toward financial services integration are analyzed, ALTA believes that the caution signals of bank and savings and loan failures coupled with the present day savings and loan confidence crisis in Ohio and Maryland should be recognized by Congress. The Committee should support legislation that would establish sound public policy by defining a bank and the types of activities in which a bank may engage. ALTA believes it is absolutely imperative for reasons stated in this submission that insurance - in particular title insurance - not be an approved bank holding company/savings and loan service corporation activity.

Please include this submission as part of the Committee's hearing record.

Sincerely,

Jack Rattikin, Jr.

Jack Rattikin, Jr.
President



Washington Office

Alliance of American Insurers
1629 K Street, Northwest, Suite 1010
Washington, D.C. 20006
202-822-8811

June 26, 1985

The Honorable Jake Garn, Chairman
Committee on Banking, Housing and
Urban Affairs
SD534
Washington, D.C. 20510

Dear Mr. Chairman:

The attached statement reflects the views of the Alliance of American Insurers regarding the appropriate legislative responses to the ongoing changes in the financial services industry. The Alliance is very much concerned with this issue and most appreciative of the Committee inviting our comments.

We request that our statement be made a part of the official hearing record.

Sincerely,

A handwritten signature in dark ink, reading "James E. Jones, Jr." in a cursive style.

James E. Jones, Jr.
Senior Washington Representative

JEJ:kh

Attachment

The Alliance of American Insurers is a major national trade association representing over 175 companies that write property and casualty insurance in all 50 states and the District of Columbia. The Alliance welcomes the opportunity to provide the Senate Committee on Banking, Housing and Urban Affairs our views regarding the appropriate legislative responses to the ongoing changes in the financial services industry. We applaud the Chairman and the members of the Committee for providing a forum for consideration, of the need, for legislative action to address these changes.

Philosophically, the Alliance encourages competition in insurance believing that such competition is in the best interest of policyholders, insurers, regulators and the public generally. However, we do believe that competitors must be treated equally and that no competitor should be permitted an unfair advantage over another. Equal treatment of institutions providing similar services should be the underlying principle of any reform of the financial services industry. Events in the financial service marketplace are running far ahead of the laws now in place. Congress must soon address deregulation within the financial services industry. One can only surmise what the various financial services entities will look like in the future, as the marketplace continues to demand changes.

The Alliance will continue to oppose legislation which allows banks to underwrite property and casualty insurance as long as such legislation fails to provide for "equality of regulation".

If banks are given the extended power to underwrite property and casualty insurance such integration must be established upon sound regulatory criteria, competition must be fair, consumers must be protected and there must be equality of regulation for all financial services institutions.

Equality of regulation demands that all competitors conform on a uniform basis to applicable laws and regulations. Consumers must also be protected from coercive practices. In order to achieve this, the following areas must be collectively addressed:

- o Regulatory Equality - All businesses must be subject to the same regulatory ground rules if they are to compete in the same areas. This requires that all insurance activities, whether of banks or of insurers, must be regulated by state insurance departments under state insurance codes. If banks are allowed to write insurance, insurers should be allowed to enter the banking industry.
- o Unfair Trade Practices - Consumers must be protected from coercion and tie-in sales through strict prohibitions and regulatory oversight.
- o Insolvency Protection - The functions and operation of the bank deposit insurance agencies, state property and casualty guaranty funds, and any other applicable insolvency mechanisms must be reconciled so that insurance guaranty funds alone handle insurer insolvencies and bank insolvency mechanisms alone handle bank insolvencies.
- o Accounting Differences - Current distinctions between banks and insurance accounting practices are essential to the safety and soundness of both businesses and must be retained.
- o Inherent Advantages - Banks should not be allowed to use low-cost depositors' funds, subsidized by federal deposit insurance, or to use funds acquired through the Federal Reserve discount window to subsidize insurance activities.
- o Corporate Structure - If banks are allowed to underwrite insurance, the Alliance recommends that they do so only through separate corporations (banks regulated by bank regulators, insurers by insurance regulators).

It should be noted that state control over all insurance activities means that insurance companies, and insurance bankholding company subsidiaries of an insurance company, should continue to be regulated at the state level; not be subject to regulation by the Federal Reserve Board; insurers should not then be prohibited by the Bank Holding Company Act from engaging in activities permitted under state insurance laws.

The Alliance opposed legislation such as Senator Garn's Financial Services Competitive Equity Act (S.2181), because the proposal did not satisfy the above mentioned criteria. The bill would have allowed banks into the insurance business, and would have regulated insurance activity on the federal level. Reemphasising our position, the Alliance would not oppose banks underwriting property and casualty insurance which provided for "equality of regulation" as outlined above and provided that:

1. Insurance companies in bank holding company systems would continue to be regulated at the state level and not be subject to regulation by the Federal Reserve Board.
2. Insurers would not be prohibited by the Bank Holding Company Act from engaging in activities permitted under state insurance laws.

The Alliance supported S.2851 in principal because of the closing of the South Dakota loophole - we continue to do so. S.2851 died because it was not considered by the House.

The Alliance opposed the South Dakota legislation which created the loophole which permitted its State chartered banks to engage in virtually any kind of insurance activity. In doing so, it carefully provided that those activities could not be performed inside the state if they would adversely affect insurance companies or agents operating within the State. But no such restrictions were applied to operations outside the State.

The Alliance is opposed to such laws which allow banks to underwrite insurance unless those laws provide an "equal regulatory playing field". Traditional barriers between insurers and banks must not be relaxed without first guaranteeing that adequate regulatory precautions have been taken.

Conclusion

In summary, if regulatory equality can be achieved the Alliance would not oppose permitting banks to underwrite property and casualty insurance. Our companies believe in competition and we do not "select" our competitors. Competition generates innovation and stimulates quality services. The problems to be overcome, however, are serious.

To a large degree, these difficulties reside in the fact that banks are unique. They are the primary source of liquidity for all other classes and sizes of institutions, both financial and non-financial.

Banks provide loans and credit and as a result, all other financial markets are dependent on the banking system as their principal source of funds. Banks can do this because they have access to deposits and the Federal Reserve system. The ultimate question, if banks are permitted to underwrite insurance "Can there be equality of regulation?". Thus far no proposal has addressed the issue of regulatory equality.

Briefly stated, the Alliance will oppose legislation that does not address the crucial issues we have raised. They include: 1) regulatory equality; 2) unfair trade practices; 3) insolvency protection; 4) accounting, and; 5) corporate structure. Only then will financial services integration guarantee a competitive marketplace.

EXHIBIT A-1

Comparison of Transactions with Affiliates Provisions
of The NAIC Model Insurance Holding Company
System Regulatory Act, The Federal Reserve Act,
and FIDIA

NAIC MODEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

"Material Transaction"

Sales, purchases, exchanges, loans or extensions of credit or investments involving one-half of 1% of more of an insurer's admitted assets, but allows the Commissioner by rule, regulation or order, to provide otherwise.

FEDERAL RESERVE ACT

"Covered Transaction"

A loan or extension of credit to the affiliate;
the purchase of or an investment in securities issued by the affiliate;
a purchase of assets, including assets subject to an agreement to repurchase from the affiliate, except purchases of real and personal property as exempted specifically exempted by the Board;
the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company;
the issuance of the guaranty, acceptance, or letter of credit on behalf of an affiliate.

FEDERAL RESERVE ACT
AS AMENDED BY FIDIA

"Covered Transaction"

Any covered transaction as defined in 21A of the Federal Reserve Act, the sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase;
the payment of money or furnishing of services to an affiliate under a contract, lease, etc.;
any transaction in which an affiliate acts as an agent, broker or receives a fee for its services to the bank;
any transaction or series of transactions with the third-party (i.e., an affiliate or the third-party) or b) an affiliate is a participant in such transaction or series of transactions.

Prohibits a bank and its subsidiaries from purchasing as fiduciary any securities or other assets from an affiliate, unless such purchases are

SAVINGS AND LOAN
HOLDING COMPANY ACT

Covered Transactions

SAL MC's subsidiary institution engaging in^a any transaction with any affiliate involving the purchase, sale or lease of property or assets (other than participating interests in mortgage loans) in any case where the sale of the consideration when added to the aggregate amount of the consideration received by such institution for all such transactions during the preceding twelve-month period exceeds the lesser of \$100,000 or 0.1% of the institution's total assets at the end of the preceding fiscal year;

entering into any agreement or understanding, (written or oral) which such affiliate agrees to (i) render management or advisory services for the institution, (ii) serve as a consultant, adviser, or agent for any phase of the operations of the institution, or (iii) render services to the institution other than those which may be required by regulation or order unless the aggregate amount of the consideration required to be paid by such institution in the future under all such existing agreements or understandings cannot exceed the lesser of \$100,000 or 0.1% of the institution's total assets at the end of the preceding fiscal year; making any payment to any affiliate under any agreement or understanding as described in (i), (ii), (iii) above where the institution has previously paid to affiliates during the preceding twelve-month period, pursuant to any such agreement or understanding, an aggregate amount of the lesser of \$100,000 or 0.1% of the institution's total assets at the end of the preceding fiscal year.

^a All the above transactions require prior written approval of the FDIC.

MAIC MOEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

FEDERAL RESERVE ACT

FEDERAL RESERVE ACT
AS AMENDED BY FIDA

"Material Transaction"

"Covered Transaction"

"Covered Transaction"

authorized by the instrument creating the relationship, by court order, or by law of the jurisdiction under which the trust is administered.

Prohibits a bank and its subsidiaries from knowingly either purchasing or acquiring any obligation for which an affiliate or subsidiary of the member bank is a principal underwriter, during the existence of any underwriting or selling syndicate.^e

^e A principal underwriter is defined to include any underwriter who, in connection with a primary distribution of securities: a) is in privity of contract with the issuer or an affiliated person of the issuer; b) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or c) is allowed a rate of gross commission, spread or other profit greater than the rate allowed another underwriter participating in the distribution. An exception to this prohibition is provided where the purchase is approved by a majority of the bank's outside directors.

SAIC WEBER
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

Definition of "Affiliate"

Person that directly, or indirectly, through one or more intermediaries, controls, or is controlled by, under common control with, or is under common control with, persons specified.

FEDERAL RESERVE ACT
AS AMENDED BY FIMA

Definition of "Affiliate"

Any company that controls the number of shares of any class of stock owned by the company that controls the number bank.

a bank subsidiary of the member bank;

any company that the Board determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank.

FEDERAL RESERVE ACT
AS AMENDED BY FIMA

Definition of "Affiliate"

The commentary supplied with FIMA suggests that although the section is intended to apply to transactions between a member bank and all of its affiliates, it is expected that the Board will "liberally utilize its authority to exclude subsidiaries engaged in existing nonbank activities." However, it should be noted that nowhere in FIMA is there a distinction made between transactions between member banks and subsidiaries engaged in banking and those engaged in non-banking activities. This section applies to federally insured non-member banks through the Federal Deposit Insurance Act.

SAVINGS AND LOAN
HOLDING COMPANY ACT

Definition of "Affiliate"

Any person or company which controls, is controlled by, or is under common control with, an insured institution.

The Act specifies that the following are not considered to be affiliates: any company other than the bank, that is a subsidiary of a member bank, (unless a decision is made by the Board to consider such subsidiary company from the definition of affiliate), or any company engaged solely in holding the premises of the member bank or engaged solely in conducting a safe deposit business.

BASIC MODEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

Definition of "Control"

Possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership, contract, or otherwise, by contract or otherwise, unless the power is the result of an official position, with or corporate officer held by the person.

Presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to veto, or holds proxies representing 10% or more of the outstanding shares of any other person. This presumption may be rebutted.

Standards to be Applied to Transaction

Terms of a transaction must be fair and reasonable;
books, accounts, and records of each party must be maintained in accordance with generally accepted accounting principles and practices;
the insurer's surplus, following any dividends or distributions to shareholder affiliates, must be reasonably

FEDERAL RESERVE ACT
AS AMENDED BY FIMA

FEDERAL RESERVE ACT

Definition of "Control"

Ownership, control or power to vote 25% or more of any class of voting securities of any other company, the control in any manner of such other company, or the power to elect a majority of directors or trustees of the other company, or where the Board determines after notice and opportunity for hearing, that such company or shareholder directly or indirectly exercises controlling influence.

Standards to be Applied to Transaction

A member bank and its subsidiaries can engage in a covered transaction with an affiliate only if:
in the case of an affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries not exceed 10% of the capital stock and surplus stock of the member bank; and

SAVINGS AND LOAN
HOLDING COMPANY ACT

Definition of "Control"

- Of an insured institution:
Ownership, control, power to vote or proxies representing, direct or indirectly more than 25% of the voting shares of such insured institution, or controls in any manner the election of a majority of its directors;

- Of any other company:
Ownership, control, power to vote or proxies representing more than 25% of the voting shares or rights of such other company, or controls in any manner the election or appointment of a majority of its directors, or in a general partner in or has contributed more than 25% of the capital of such other company...

- Of either, if FELIC:
Determines, after reasonable notice and opportunity for hearing, that such person directly or indirectly exercises a controlling influence over management or policies.

* Exemptions for companies owning/controlling voting shares of SLL or SLL MCs acquired in connection with the underwriting of our lines held for less than...

Standards to be Applied to Transactions

The FELIC shall grant approval if the terms of any such transaction, agreement or understanding, or any such payment by such institution, would not be detrimental to the interests of its savings account holders or to the insurance risk of the Corporation with respect to such institution.
The Corporation shall grant approval of any application for approval of any loan, discount, extension of credit to any affiliate or any third party on the security of any

**BASIC MODEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT**

**FEDERAL RESERVE ACT
AS AMENDED BY FIMA**

**SAVINGS AND LOAN
HOLDING COMPANY ACT**

**Standards to be
Applied to Transaction**

able in relation to the insurer's liabilities and adequate to its financial needs.

**Standards to be
Applied to Transaction**

in the case of all affiliates, the aggregate amount of covered transactions not exceed 20% of the capital stock and surplus of the member bank.

Any transaction is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the purchase of or transferred to the affiliate; a member bank and its subsidiary must purchase low quality assets from an affiliate unless such bank or subsidiary, pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time the asset was acquired by the affiliate; and any exempt transactions as well as exempt transactions must be on terms and conditions consistent with safe and sound banking practices.

Adequacy of Surplus

Among the factors to be considered are:

the size of the insurer as measured by its assets, capital and surplus, reserves, premium writings, liquid-

**Standards to be
Applied to Transaction**

in good faith would be offered, or would apply to nonaffiliated companies."

**Standards to be
Applied to Transactions**

property acquired from an affiliate if, in the opinion of the Corporation, such a loan, etc. would not be detrimental to the interests of savings account holders, or to the insurance risk of the Corporation, and would be in the best interests of the Corporation. (1) Property purchased from any savings and loan holding company or any affiliate thereof other than such service corporation, or (2) property heretofore owned, by any savings and loan holding company or affiliate thereof.

FELIC shall grant approval of holding company indebtedness where FELIC finds that proceeds of transaction will be used for (1) the purchase of permanent, guaranty or other insurance, or (2) the purchase of stock in a subsidiary of insured institution, or (3) the purpose of making a capital contribution to a subsidiary insured institution, or such act/transaction is required for the purpose of refinancing, extending, exchanging or discharging an outstanding debt security, or for other necessary or urgent corporate needs and would not impose an unreasonable or imprudent financial burden on the applicant.

Collateral

The Federal Reserve Act specifies that collateral for each loan or extension of credit to, or guaranty, acceptance or letter of credit issued on behalf of an affiliate by a member bank or its subsidiary shall

Adequacy of Surplus

ance in force and other "appropriate criteria".

the extent to which the insurer's business is diversified among several lines of insurance and the extent of the insurer's diversification of the insurer's insured risks.

recent past and projected future trends in the size of the insurer's surplus;

the quality and liquidity of investments in subsidiaries made pursuant to Section 2 of the Federal Act, which provides that any domestic insurer may not acquire or acquire an interest in a subsidiary of a foreign insurer; this section provides that the Commission may treat any such investment in a subsidiary made pursuant to Section 2 as a disallowed asset for purposes of determining the adequacy of surplus as regard policyholders' interests, in his judgment, such investment so warrants.

Collateral

be secured at the time of the transaction by collateral having a specified market value equal to:

100% of the amount of such loan or extension of credit, guaranty, acceptance, etc., where the collateral is composed of securities of the United States, its agencies, notes, drafts, etc.;

110% of the amount of such loan, etc. if the collateral is composed of obligations of any state or political subdivision;

120% of the amount of such loan, etc. if the collateral is composed of stock, leases or other real property;

130% of the amount of such loan, etc. if the collateral is composed of stock, leases or other real or personal property.

Any collateral subsequently retired or amortized must be replaced by additional eligible collateral needed to keep the percentage of the collateral value relative to the amount

BASIC MODEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

FEDERAL RESERVE ACT

FEDERAL RESERVE ACT
AS AMENDED BY FIRM

SAVINGS AND LOAN
HOLDING COMPANY ACT

Adequacy of Surplus

Exemptions

Any insurer, information or transaction if and to the extent that the Commissioner by rule, regulation, or order shall exempt the same.

Collateral

of the outstanding loan. (Securities issued by an affiliate of the member bank are not acceptable as collateral.)

Exemptions

1. Any transaction with a member bank
 - a. which controls 50% or more of the voting shares of the member bank,
 - b. in which the member bank controls 50% or more of the voting shares, or
 - c. in which 50% or more of the voting shares are controlled by the company that controls 50% or more of the voting shares of the member bank.
2. making deposits in an affiliated bank in the ordinary course of correspondent business.

Exemptions

The Federal Reserve Board is authorized to prescribe rules and regulations to carry out the purposes of the provisions and to allow the exempt transactions or relationships from the section's requirements, where the exemption is in the public interest.

Holding Company Indebtedness/Exemptions

SALMC or its subsidiary which is not an insured institution cannot issue, sell, renew, or guarantee any debt without the approval of the Federal Reserve Board without FSILC's prior approval, with exceptions for

- diversified SALMC or their subsidiaries or
- issuance, sale, renewal or guaranty of any debt security, or assumption of any debt by any SALMC or subsidiary if the security/debt aggregate, together with all other securities/debt not more than 15% of HC's or subsidiary's consolidated net worth at end of preceding year.

Where a diversified SALMC does not meet this test, neither the HC nor any subsidiary thereof may accept/receive benefit of any dividend on stock from a subsidiary insured institution and such institution may not declare/pay any dividend on its stock to such HC/subsidiary unless FSILC fails to object, within 30 days to such dividend as being injurious to the insured institution in light of its financial condition and prospects.

FEDERAL RESERVE ACT
AS AMENDED BY FIMA

FEDERAL RESERVE ACT

Exemptions

3. giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.
4. making a loan or extension of credit to, or issuing a guaranty, acceptance, etc. on behalf of an affiliate that is fully secured by
 - a. obligations of the U.S. or its agencies,
 - b. obligations guaranteed by the U.S., its agencies, etc.,
 - c. a segregated escrowed deposit account with a member bank.
5. purchasing securities issued by any company engaged solely in one or more of the following activities
 - a. holding or operating properties used wholly or substantially by any bank subsidiary in the operations of the bank subsidiary or acquired for future use,

MAIC MODEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

Exemptions

NAIC MODEL
INSURANCE HOLDING COMPANY
SYSTEM REGULATORY ACT

Exemptions

FEDERAL RESERVE ACT
AS AMENDED BY FIMA

FEDERAL RESERVE ACT

Exemption

- b. conducting a safe deposit business,
- c. furnishing services to or performing services for a bank holding company or its banking subsidiary,
- d. liquidating assets acquired from a bank holding company or its bank subsidiary prior to May 9, 1956,
- e. purchasing assets having a readily identifiable and publicly available market quotation, and
- f. purchasing from an affiliate a loan or extension of credit that was originated by the bank or bank and sold to the affiliate subject to a repurchase agreement.

The Board may, at its discretion, by regulation or order, exempt transactions or relationships if such exemptions are in the public interest and consistent with the section's purposes.